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METHODS OF AMALGAMATION

AND

THE VALUATION OF BUSINESSES

FOR AMALGAMATION & OTHER PURPOSES

BY

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PREFACE TO FIRST EDITION

No book on the subject of "Amalgamations" appears to have been published in this country, although many amalgamations of industrial and other concerns have taken place within recent years, and it seems likely that this tendency will continue, as, in the realms of both Capital and Labour, consolidations and alliances are frequently under consideration.

A considerable portion of this book will be found to be devoted to the question of the valuations of businesses for amalgamation purposes: and nearly the whole of the considerations present in this connection apply also to the valuations of businesses for purposes other than amalgamations. In view of these circumstances, I have introduced as the sub-title of the book the words "and the valuation of businesses for amalgamation and other purposes".

In the last Chapter (No. XVI.) will be found noted a few general comments on valuations of businesses which may be made for objects other than amalgamations.

I hope that this book may be of service to practising Accountants and also to such of the commercial and financial community as may have cause to be interested in amalgamation schemes or in the valuation of businesses for other purposes.

I am indebted to Mr. P. D. Leake and to Professor Dicksee for permission to quote from their valuable works on the subject of Goodwill.

A. E. CUTFORTH

5 London Wall Buildings
London, E.C.2
July 1926

PREFACE TO SECOND EDITION

The demand for this book has necessitated the preparation of a second edition. Practically no alterations have taken place in the manner in which the subject matter has been arranged and presented : various modifications and corrections in matters of detail have, however, been made as a result of helpful comments and criticisms from the Press and other sources on the publication of the first edition.

Some general observations have been introduced on the causes which have tended to bring about amalgamations during recent years : and in appropriate places will be found comments upon and extracts from the following Acts of Parliament which deal, *inter alia,* with matters incidental to amalgamations :

Mining Industry Act 1926
Finance Act 1927
Finance Act 1928
Companies Act 1929
Coal Mines Act 1930

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London, E.C.2
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CHAPTER I

PRELIMINARY REMARKS

THE word "Amalgamation" is described in the dictionary as meaning " the blending of different things ". Another definition given by a dictionary (and an apt example of the art of describing the meaning of a long word by the use of other long words) is " a homogeneous union of diverse elements ".

It may therefore be advisable to observe, at the outset, that the word " Amalgamations ", as dealt with in this book, is used solely in the business sense. That is to say, it refers to the amalgamation of businesses or undertakings.

It is also necessary to explain that what is commonly termed an " amalgamation " of businesses does not necessarily mean that the businesses themselves become merged in one ; for example, a Limited Company owning a business may acquire, by purchase, the whole of the Share Capital of another Limited Company which owns a competing business. In effect, an amalgamation has occurred, although the two businesses may continue to be carried on in their own names and, to all outward appearances, in competition.

In the great majority of cases, however, an amalgamation of businesses or undertakings does mean that in respect of such businesses the interests of the owners are made identical, or, in other words, are unified.

From the above point of view it is probable that the word " merger " would be a better term to use than the word " amalgamation ", as it is of wider application. The word " Amalgamation " has been chosen, however, as

that word is the one most commonly used by the business community when referring to a unification of interests.

A merger of the interests of two or more businesses or undertakings may be a merging in whole or only a merging in part.

As an instance of a merging in part, there may be quoted an arrangement for a pooling in regard to sales—that is to say, where a standard or ratio is fixed, based on past results, in regard to the sales of each business, and where a certain rate of payment is made in the future by the business whose sales exceed its standard or ratio to the business whose sales fall short of its ratio. Although such arrangement may be in force, it may still be to the advantage of each business to extend its sales as much as possible *vis-à-vis* the other business, or businesses, as the sum which one business might receive under the pooling agreement, as a result of its sales falling below its standard proportion, may be insufficient to compensate it for the resultant loss of profit. Further, the interests of each of the businesses would be in no way unified in regard to purchasing or manufacturing; the community of interests would relate merely to sales.

Again, a merging of interests, although complete (as opposed to partial), may be temporary (as opposed to permanent). For example, two businesses may enter into a Pooling Agreement, whereunder the whole of their net profits are first brought into a common fund, or pool, and then distributed in certain defined proportions. The Pooling Agreement, while it lasts, does effect a complete unity of interests; but if a date is fixed for the termination of the agreement, the merging of interests is obviously temporary only.

As will be appreciated, the vast majority of businesses or undertakings fall under one of the following categories:

(*a*) Businesses owned by individuals, or
(*b*) Businesses owned by firms, or
(*c*) Businesses owned by Limited Companies.

Notwithstanding the difference in the class of ownership, it is possible for the interests of (*a*) to be merged with (*b*), or (*b*) with (*c*) or (*a*) with (*c*), without existing identities being interfered with. For example (*a*) and (*b*) may become parties to a Pooling Agreement relating to profits, as may also (*b*) and (*c*) or (*a*) and (*c*).

Then again, there is nothing to prevent the owners of (*a*) or of (*b*) acquiring the whole of the Share Capital of (*c*) and thus effecting a community of interests between the respective businesses.

And further, a Limited Company can become a partner in a firm.

The foregoing general observations have been submitted at the outset, in order that the reader may not approach the subject of Amalgamations with too limited a conception of its scope.

Comparatively speaking, business amalgamations are of recent origin. In other words, the number of mergers now occurring annually is probably many times greater than the number occurring say twenty-five years ago; and most certainly immeasurably greater than the number occurring fifty or sixty years ago. Strictly speaking, a consideration of the reasons for this does not lie within the scope of this book. It is, however, thought well that the reader should appreciate that to a considerable extent the cause is to be found in certain changes in the conditions under which industry is carried on to-day as compared with those existing half a century ago. The following observations may therefore be helpful.

In the first place, it is submitted that one of the

reasons for the increase in the number of amalgamations is the development of Joint Stock enterprise.

Fifty years ago most businesses were probably under private ownership, and, in comparison with the state of affairs to-day, few Limited Liability Companies existed. This meant that in the majority of cases the growth and development of a business was limited by the amount of fresh capital (usually in the form of undivided profits) which the owner of the business—or the partners in that business in the case of a partnership—were able to put into it. And the same limitation frequently applied in regard to absorptions of or amalgamations with other businesses, where such arrangements necessitated the finding of additional capital.

When, however, businesses became, to a much greater extent, carried on by public Limited Liability Companies, these restrictions on development largely disappeared. The ownership of a business, instead of resting in the hands of a single person or a few men in partnership, was divided among several hundreds and perhaps thousands of shareholders. Consequently, when those in charge of the management of the business—that is to say, the Directors—came to the conclusion that fresh capital could be profitably employed, either in extending the business or in acquiring another business to be run in conjunction with it, they could appeal to the shareholders or even to the general public to subscribe for the capital in question, and, under ordinary circumstances, there was not usually much difficulty in obtaining it.

So it has come to pass that the development of what is known as Joint Stock enterprise—in other words, the ownership of businesses by Limited Liability Companies—has made the road to amalgamations more easy.

But there is another circumstance—or set of circumstances—which has done much to facilitate amalgamations, namely, the great improvements which have taken

place during the last fifty years—and particularly in the last twenty-five years—in the means of communication. The bicycle, the motor cycle, the motor car, the power of the Press as an advertising medium, the telephone, the typewriter, and more latterly the wireless and the aeroplane, have all played and are playing their part. Businesses which are the subjects of amalgamation are frequently situated at considerable distances from each other; but notwithstanding this, the amalgamation implies that the resources must be pooled and that the administration must be directed from a single point. If means of communication between the one business and the other are not expedited and simplified as much as possible, the benefits which the amalgamation is designed to bring may not be fully secured.

While improvements in the means of communication have facilitated the working of businesses in conjunction with each other, they have also led to more competition; in other words, businesses can make their power felt over a wider area than would otherwise be the case. Where competition is keen, it is the strongest, *i.e.* the most powerful, who ultimately survive. This of itself leads businesses to enter into alliances with each other, and pool their resources, both in money and brains, in order to keep abreast of their rivals.

Many examples of the effect of improved communications are to be found, for example, in London, where the development of the motor bus, tram, and underground railway services have brought tens of thousands of suburban shoppers to the great retail Stores in Oxford Street, Kensington High Street and other parts, the Stores themselves being able, through their highly organised motor-van services, to deliver at the customers' door the goods purchased. And the development of the telephone services has added enormously to the convenience of shoppers who deal at these large Stores.

In quite a number of cases several of these great Stores are under common ownership; that is to say, they represent amalgamations, although each may still be carried on under its original name, to which a valuable goodwill may attach. The increased trade which they are able to do each year represents, to a considerable extent, trade which has been lost by the small draper, grocer, etc., in the suburbs of London, who has to stand on his own small feet and whose resources, both in money and experience, are, by comparison, very limited.

Another cause which has led to many amalgamations during recent years, and which will presumably continue to be operative for some little time yet, is the effect, upon certain industries in this country, of the Great European War. The industries concerned are those engaged in production rather than in distribution; and prominent among them are the coal, iron and steel industries, and the shipbuilding industry. The demand for munitions and other war requirements, and the reconstruction and other work which accompanied the change over from war-time to peace-time activities, including among other matters the work of house building and the undertaking of other arrears of what may be called "peace-time work", caused—and in some cases even forced—manufacturers to extend their works, and it also induced many people to set up small works which, in normal times, could not prove to be anything but uneconomic. As a result, this country found itself, when the war work was finished and the short post-war boom had passed, with a productive capacity in the form of works, factories, plant, machinery, etc., very much in excess of any likely demand, and, furthermore, a considerable number of the establishments were not easily adaptable for normal classes of work, while others, either owing to their small size or their geographical situation or for other reasons, were not capable of producing sufficiently economically to permit of their

making a living in a world where supply had once more overtaken demand. And the difficulties of the situation are enhanced by reason of the fact that a number of foreign countries in which the post-war standard of living is considerably lower than in our own are, in consequence, able to produce many commodities at lower prices than we can do, and are thereby in a position to capture some of our export trade to which, in pre-war times, so much of this country's prosperity was due. Very many undertakings—and one is thinking in particular of the heavy industries such as coal, iron and steel—are operating at little or no profit, and in many cases at an actual working loss. There is not enough trade for them all: and therefore few are working to anything like their full capacity. From time to time works are closed down altogether and therefore fall out as economic units: but the process is slow, and to many who are still struggling on death must come in due course, as losses eat up the floating resources and render further operation impossible. It is in such cases that amalgamation between competing businesses may very much improve the situation. Under an amalgamation a number of the worst-situated or worst-equipped works could be closed down (their owners receiving compensation) and production concentrated in the remaining and more efficient works. By this means the costs of production would be very much reduced, as, apart from all other considerations, costs are almost invariably lower the more fully occupied a works or factory may be, as the standing charges (that is to say various classes of expense which, relatively speaking, are fixed in amount and do not vary in ratio to the output) are thereby spread over a much wider area, and are consequently lower in ratio to the direct costs than would otherwise be the case. The savings resulting from an amalgamation in such circumstances may be sufficient to yield an increase in income to those owners of works which the combine will continue

to operate, and also to cover the equivalent of interest on the compensation payments to owners whose works, when taken over by the Combine, are going to be "scrapped".

It is probable that other factors have also contributed towards inducing amalgamations—such as the increased use of machinery; mass production; the tendency of business generally to become more complicated; the growth of industrialism in foreign countries and their consequent competition with this country in certain manufactures. All these things call for greater strength and more highly developed organisations on the part of businesses in this country, and, as has already been indicated, it is the most powerful, in mental and material resources, who are the ultimate victors in a war of competition.

CHAPTER II

OBJECTS SOUGHT TO BE GAINED BY AMALGAMATIONS

THE objects which are sought to be achieved as a result of Amalgamations are many and varied.

A summary is set out below of certain advantages which do, or may, accrue from such mergers. It is not suggested that this summary is in any way complete, nor, on the other hand, of course, is it to be inferred that, in the case of every merger, all of the benefits described below accrue.

Not infrequently one hears the expressions "vertical combine" and "horizontal combine". It may be appropriate here to explain that a "vertical combine" or amalgamation is one between businesses which pass on their products to one another. For example, three businesses may be amalgamated of which one manufactures a certain class of article, another sells the same class of article as a wholesaler, while the third sells the same class of article (and not improbably other classes of articles as well) to the public through the medium of retail shops.

By this means the manufacturing side of the business is assured of a market for a whole or a part of its product, through the medium of the wholesale business; and the wholesale section is assured of the disposal of the whole or part of the goods or articles with which it deals, through the medium of the retail shops.

Thus the profits of the combine as a whole consist, in part, of a manufacturer's profit, in part of a wholesaler's profit and in part of a retail trader's profit.

The "horizontal combine" on the other hand is one between businesses of the same nature—as, for example,

between a number of manufacturing businesses, or between a number of merchanting businesses. The benefits which may be reaped from such a class of combine will be found referred to in succeeding paragraphs of this Chapter.

As regards the "vertical combine", it will be appreciated that the administration of this calls, in an ordinary case, for a greater variety of skill and experience than the administration of a horizontal combine. To the uninitiated it might appear that a combine, which undertakes the functions of manufacturer, wholesaler and retailer, and can therefore retain for itself the whole of the profit made in manufacturing and in distributing to the ultimate consumer, must necessarily be in a favoured position as compared with a business which only exercises one of these functions. But it must be remembered that each class of business calls for special experience and has its own special problems. Manufacturing businesses are concerned with matters such as the purchase of raw materials, labour problems, works management, engineering questions and so on. Distributing businesses are concerned with questions relating to salesmanship, the purchase of manufactured articles, advertising, propaganda, terms of credit to customers, etc. It may be the case that the Board of a Combine is sufficiently rich in the qualifications of its members to supervise or secure the adequate supervision of these different classes of functions, and the character of the undertaking may be such as to lend itself to vertical combination ; indeed one hears of not a few cases of this character. But on the other hand one meets—and possibly with greater frequency—cases where a producing or manufacturing business has decided to enter the distributing and selling market, and has found the venture unprofitable. In the majority of cases experience has taught the soundness of the dicta that the cobbler should stick to his last, and that to be Jack of all trades is to be master of none.

1. Economy in Capital Expenditure

It not infrequently happens, particularly in regard to manufacturing concerns, that, when an amalgamation takes place, the assets representing past capital expenditure can be utilised to better advantage and future capital expenditure minimised.

For example, Works which are most favourably situated for economic operations can be utilised to their full capacity, and Works which are not so fortunately situated can be disposed of, the loss on the realisation of the last-mentioned Works being more than offset by the enhanced earning capacity of the first-mentioned Works.

Or again, if two businesses are, in effect, merged, and the orders received at one Factory are more than sufficient to keep that Factory fully employed, the surplus work can be undertaken by another Factory, instead of, as might otherwise be the case, the orders having to be refused, or, alternatively, extensions having to be made to the first-named Factory.

Furthermore, when new Plant and Equipment has to be bought, a large undertaking, representing a combination of several businesses, is frequently in a position to make these purchases on better terms than a relatively small business is able to do.

2. Economy in the Use of Floating Capital

Where two or more businesses are amalgamated, or are working in unison, a smaller amount of Floating Capital is not infrequently necessary than would be the case were each of such businesses competing with the other. For example, if one of the businesses finds itself temporarily short of Stock-in-Trade, the deficiency can be made good from another business. Further, the businesses, when operated in combination, should be in a

better position to borrow from bankers, or others, any sums necessary for temporary finance: and such being the case, the businesses may not require to maintain so large an amount of permanent floating capital.

3. Economy in Buying

As a general rule, purchases, whether of raw materials or stores, can be made on more favourable terms if such purchases are very large than if they are relatively small: and one of the first matters which is usually given attention to on a merger is the centralisation of the organisation in connection with the buying of materials, etc. Frequently, also, the absence of competition enables the goods in question to be purchased more cheaply. Another advantage in connection with buying is that, as the result of a merger, the direction of the buying would naturally be placed in the hands of the individual who had in the past proved himself to be the most skilful and experienced buyer.

4. Maintenance of Selling Prices

Amalgamations are calculated to prevent or to minimise reductions in selling prices which result from the "cutting" which is due to excessive competition.

5. Economy in Advertising Expenses

Where two or more competing businesses are incurring heavy advertising expenditure, a merger not infrequently has the result either of reducing the total expenditure under this head, or, alternatively, of making it more effective. In a case, for example, when a merger has taken place and each business is still conducted in its old name —to which a valuable goodwill is attached—a collaboration, as regards the advertising campaign, may lead to

one business increasing its advertisements regarding a particular line of goods, while the other business may reduce its advertising of a similar line or lines. Or, again, one business may extend its advertising programme in certain districts where its products are in special favour, leaving the other business to develop a publicity campaign in other areas where there is better prospect of success.

Furthermore, a large combination, which has the placing of correspondingly large advertising contracts, should be able to arrange these on more favourable terms than would a small business with relatively small advertising contracts to place.

6. Saving in Distribution Expenses

In cases where a merger of interests takes place in connection with Manufacturing Concerns having Factories or Works in different places, a redistribution of the work can not infrequently be made with a view to each Works, or Factory, supplying, as far as possible, the area in its own neighbourhood, thus effecting considerable savings in railway freight and cost of distribution by road.

7. Economy in General Trade Charges

As the result of the larger output at a Factory, or Works (see under 1), the general, or indirect, operating costs form a smaller ratio to the sales than would otherwise be the case, and this enables the total costs, per unit of output, to be proportionately reduced. For example, in the case of amalgamations of Breweries, the brewing processes may be centralised as far as possible in the most efficient Breweries, and the Breweries which cannot be so economically worked are abandoned. The fact of the most efficient Brewery maintaining an output approaching its

maximum capacity has a beneficial bearing on working costs.

8. Greater Stability by Reason of Geographical Decentralisation

If, owing to a merger, various Works or Undertakings in different parts of the country fall under the same ownership, the Undertaking as a whole may be in a sounder position in the event of upheavals such as strikes, which may be local in character. Should such a misfortune overtake any one of the Works or Factories, arrangements could be made with a view to passing on, as far as practicable, to the other Factories the work which would otherwise have to remain unperformed.

Similar remarks apply to a circumstance such as a serious fire, which, in the case of a business comprising one Works or Factory only, may be disastrous from the point of view of the continuity of the operations, but which, in the case of an undertaking comprising Factories in various places, is not so crippling in its effect.

9. Saving in Administration Expenses

As a result of the combining of two or more businesses, there should be a material saving in administration expenses, such, for example, as the cost of secretarial and accountancy work. Further, in proportion to the size of the business, the number of administrative posts, such as those of Directors and Managers, should be capable of being curtailed, with a consequent saving in expense.

10. Greater Financial Strength

A combination of businesses should, by reason of its size, have greater financial strength. Its credit should be

improved and facilities for raising moneys, either from bankers or from the public, should be enlarged. Furthermore, this financial strength should stand the business in good stead in the case of prolonged misfortunes arising from circumstances such as abnormal stagnation in trade, strikes, or a "prices war".

11. Greater Stability as regards the Work of Administration

It not infrequently happens that an undertaking largely owes its success to the ability and efforts of one man; and in such a case the continued success of the business is dependent to a considerable extent upon that man's health, or to his willingness to continue at his post.

In a combination of businesses, however, the administrative work is, as a rule, shared by a number of men, and greater stability is therefore ensured, as the breakdown in health of one of such men should not jeopardise the continued success of the business. Further, in a small business it occasionally happens that young men of ability find the road to success blocked by other men of greater age and experience; as a consequence they may resign their posts and go elsewhere; and when the vacancy in the business does occur there is no one on the staff who is capable of filling it, and an individual has consequently to be found from outside, and not infrequently at short notice. The dangers of such a situation are obvious. In a very large business, however, where the administration is shared by a number of men, it is usually possible to give the young men who are developing favourably adequate opportunity for using their abilities to the best advantage, and remunerating them accordingly.

12. Amalgamations involve a Pooling of Brain Power

Great benefits are frequently reaped as the result of amalgamations, owing to the fact that in each department or section of the combined business the best brains from among the component businesses can be utilised.

This may lead, for example, to greater skill in buying; to an improvement in the manufacturing processes; to more enterprise and initiative in selling; to better methods of finance; to improved handling of labour; to the better utilisation of plant, etc. The advantages under certain of these heads have already been commented on in preceding paragraphs. It is possible, in a large undertaking, for various officials to specialise, and by so doing to improve their value to the business. In small undertakings, however, those in charge must be prepared to deal with many and varied matters, and this prevents, to a considerable extent, their gaining any very specialised experience in one department or section.

13. Improved Facilities for disposing of Owners' Interests in a Business

Where, as is most frequently the case, an amalgamation results in the various businesses being owned by a single Limited Company (either direct or through a shareholding), a part proprietor of the combined undertaking can more easily dispose of his interest therein during his lifetime (should he wish to do so) than would be the case were he the sole owner or the predominant partner in a single business.

The interest would be represented by shares, on which the liability was limited—a convenient form from the point of view of marketability. Further, the same advan-

tages would be present in the event of the death of the owner of the shares, thus simplifying matters for his executors.

If the shares in question represent part of an issue for which a Stock Exchange quotation has been obtained, their marketability is still further improved.

The advantages which ownership by means of a shareholding in a Limited Company confers, as compared with the ownership by a firm or an individual, are numerous: and it is not within the province of this book to describe them. If the reader wishes to pursue this matter further, he is recommended to read *The Promotion and Accounts of a Private Limited Company*, by Sir Mark Webster Jenkinson (published by Gee & Co.).

Where an individual is the sole, or the main, owner of a comparatively small business, he will, in the majority of instances, find it more difficult to dispose of his interest than if he were only the possessor of a small share or proportion of a large combination of businesses. In the latter case it would probably be easy for him to sell his interest to one or more of the other proprietors.

Another point to be borne in mind in this connection is that the greater the stability of a business and the broader its foundations, the higher the price that can be obtained on the sale of an interest therein.

14. Improved Services to the Public

It is claimed for many amalgamations of industrial enterprises that as production is thereby increased and also made cheaper, the public should benefit, as a large output, coupled with efficient means of production, should allow of a reasonable profit to the "Combine", and at the same time a lower price to the public than would otherwise be possible.

15. Greater Security as regards Supplies of Material or Goods needed

Under what is known as a " vertical combine "—to which reference has been made at the beginning of this chapter—a very important advantage frequently lies in the safeguarding of the position as regards raw material required, bearing in mind that in the absence of such supplies being forthcoming as and when wanted the business in question would be brought to a standstill. Examples of this are the ownership by iron and steel concerns of coal mines from which to obtain the coal necessary for their manufacturing businesses, and the ownership by newspaper concerns of forests and paper manufacturing plants in order to ensure a regular supply of paper which, under other circumstances, might not always be forthcoming.

16. Greater Security as regards Market for Sales

This point has already been touched upon at the commencement of this chapter where reference was made to " vertical combines ". An example of this particular advantage is afforded by the frozen meat trade, in which owners of the freezing establishments abroad or in the colonies are also proprietors of retail shops in certain of the countries in which they dispose of the product of their factories.

CHAPTER III

POSSIBLE OBJECTIONS TO AMALGAMATIONS

In the previous chapter a list of the possible advantages to be gained by Amalgamations was set out. It must not, however, be inferred that no objections to Amalgamations exist.

Exploitation of the public.

One of the criticisms which is not infrequently levelled against Combines or Trusts is that they are in a position —and take unfair advantage of that position—to "corner" commodities or services, and so to force up the price of either against the consumer or user. A powerful Combine can, for instance, engage in a price-cutting war, whereunder its output is sold at unremunerative prices, and by this means it can "freeze out" less powerful parties engaged in the same trade. Having by these means reduced, or eliminated, competition, the Combine can then sell its products at unfairly high prices, and so exploit the public.

In some instances, no doubt, criticisms of this character may be well founded; but in the great majority of cases it will probably be found, on careful and detailed enquiry, that they have no substance.

Expense and inconvenience, without corresponding advantages.

All businesses are not of a character where amalgamations can take place with very profitable results; and, as amalgamations are not unattended by expense and inconvenience, it is very necessary that the interested parties should, before pledging themselves to any course of action, consider very carefully the difficulties and objections as well as the advantages.

Certain forms of amalgamation are more expensive

than others: and the question of the expenses—both in character and amount—attendant on each of the different forms of amalgamation will be found dealt with in a later part of this book. It may, however, be mentioned here that the two chief classes of expense are stamp duties (*e.g.* on the transfer of assets or shares from one ownership to another; and on the authorised Share Capital of a new Limited Company) and the costs of the valuations of assets for the purpose of arriving at the relative values of the businesses which are the subject of the merger.

The Legislature has recently been impressed with the need for facilitating amalgamations in proper cases; and certain reliefs have been granted in connection with the above referred to duties by the Mining Industry Act 1926 (as regards Collieries), and by the Finance Acts 1927 and 1928, as regards Limited Liability Companies operating under the Companies Acts. Reference to these reliefs will be found later in this book.

Elimination of the personal element.

Certain businesses largely owe their success to the personal element, that is to say, to the personality and personal efforts of their Proprietor or Proprietors. If businesses such as these become merged in a Combine, there is a danger that the beneficial effects of this personal element may be lost. The personal ties may have existed between the Proprietor of the business on the one hand and the staff and workpeople on the other; or, again, they may have existed between the proprietors of the business and the customers of that business. Both as regards workpeople and as regards customers, the knowledge that the business is no longer solely owned and personally supervised by the old proprietors may have an adverse effect.

The larger a business becomes, the more difficult it is to provide for personal contact between the customers on the one hand and those directing the business on the other hand. And the same remark applies as regards the con-

tact between those at the head of the administration and the workpeople. Between a Managing Director on the one hand and a workman on the other a wide gulf is fixed, and this gulf is bridged by a number of intermediate officials or employees, such as Departmental Managers, Shop Managers, Foremen, etc. Unless each of these parties is strongly influenced or efficiently controlled by those immediately above him, and exercises, in his turn, a strong influence and control over those immediately below him, there is the danger that the general control by those at the head of the business may become ineffective. And where a business is maintaining a large output and making, on such output, a comparatively small rate of net profit, any wastage or leakage, owing to a lack of control, must be serious, bearing in mind that it affects such large figures.

Difficulty of managing very large undertaking.

Somewhat akin in principle to the foregoing objection is the following difficulty which is being experienced in connection with some of the very large amalgamations during recent years. The combined undertaking is of such a size that it needs a superman to organise and manage it effectively: and supermen are very rare.

Elimination of trade names.

Objections are occasionally raised by parties contemplating amalgamation, on the ground that the businesses in question have valuable trade names, and that such trade names might be lost, or at all events might lose some of their value, on an amalgamation. The writer does not, however, know of a case where such an experience has resulted.

If an amalgamation is effected by means of a Company holding the whole of, or a controlling interest in, the Share Capital of another Company, each business would, of course, continue to be carried on under its own name, and, to all outward appearances, in exactly the same manner

as previously. Under such circumstances no difficulty can arise.

In cases, however, where two or more businesses, as such, are amalgamated, different considerations arise. The amalgamation would, in all probability, be carried out by means of a Limited Company which would purchase the assets and goodwill of each business: and the question to be decided is what name shall be given to the Company, bearing in mind that each business has hitherto carried on its operations under a name which is perhaps a household word, and therefore of great value from the point of view of goodwill. In circumstances such as these it is usual either for the Company to adopt a name in which the names of the merged businesses appear, or else for the Company to take an entirely new name, but for each business to have in all prominent places (such as its letter paper, its shop windows, its advertisements, etc.) in large type "THE X BRANCH", followed, in small type, by the words "of the Y Company, Ltd." ["X" representing the trade name of the old business to which valuable goodwill is attributed, and "Y" representing the name of the new Company].

As an example of the former alternative there may be quoted the amalgamation of the Sugar Refiners, "Henry Tate & Sons, Ltd." and "Abram Lyle & Sons, Ltd.". The Company which now owns both the businesses is known as "Tate & Lyle, Ltd.". As an example of the latter alternative may be mentioned the combination of Tobacco businesses which was effected when the Imperial Tobacco Company of Great Britain and Ireland was formed. Among the businesses taken over were those having such well-known names as "W. D. & H. O. Wills", "John Player & Sons". These names are still in prominent use by the "W. D. & H. O. Wills Branch" and the "J. D. Player Branch" of the Imperial Tobacco Company.

Difficulties in connection with centralisation and decentralisation.

Objections, sometimes sound, but probably more often ill-founded, may be made to amalgamations on the ground that where centralisation of management and administration is necessary for the success of a business, it is frequently absent in a large combination owning businesses in various different localities; and, conversely, that where close supervision on the part of those occupying high administrative posts is called for, and where uniformity of methods and policy is very desirable, these desiderata are absent, owing to the seats of operations being situated in so many different places.

That disadvantages under these heads may be experienced cannot be denied: but if the arrangements relating to management and administration are carefully worked out, the difficulties should, in the main, disappear. Some matters—such as, for instance, the buying of raw materials and the fixing of selling prices—clearly lend themselves to centralisation. Other matters—such as works management—obviously cannot be dealt with to any great extent at a head office of a Combine, but must be taken up and decisions made at the different factories or works.

It is not infrequently the case, in connection with amalgamations, that the Board of Directors responsible for managing the Combine is a large one, in order that all interests may have representation. This does not, however, mean that it is necessary that all matters which, in a smaller undertaking, would be referred, for discussion and decision, to a Board which might consist of, say, four or five members, would be brought before a Board numbering perhaps fifteen to twenty men. A very considerable part of the work would in the latter case be performed by small Committees of the Board, or by Committees composed partly of members of the Board and partly of officials such as Works Managers and Departmental Managers. The more important matters dealt

with by such small Committees would be subsequently submitted to a full Board for ratification or approval: this being in many cases a formality only. In some very large Combines it is usual for the Board to delegate very wide powers of action to quite a small Executive Committee of the Board, which Committee might meet as often as once or twice a week, while the Board as a whole might not meet more frequently than once in every three months. Or alternatively there may be two or more of such Executive Committees, each of which would specialise in certain sections or departments of the business.

Relinquishment, by previous owners, of control.

Another, and much more frequent, objection to amalgamations arises from *amour propre*, or personal feeling. Men who have been accustomed to a personal domination, almost amounting to dictatorship, in their own businesses, do not take kindly to a change of circumstances whereunder they merely become members of a Board of Directors, and may find themselves, in important matters of policy, in a minority, and therefore subject to the control of others. The amalgamation may, it is true, be arranged on lines which provide that such men shall, in effect, continue to manage personally the business, or businesses, with which they have been identified in the past. But this management does not imply unfettered control. Managing Directors and Managers are subject to the control of a Board of Directors, and the Board, in its turn, is subject to the dictation of the shareholders of the Company. Unless, therefore, the dominant personality of the past finds himself, as the result of the amalgamation, to be the owner of a sufficient number of shares to carry, by voting power, a control over the affairs of the Company, he must be prepared to defer, in matters of management and the like, to the wishes of others.

Jealousies.

Another factor which sometimes militates against

the obtaining of full advantages from an amalgamation is that of jealousies which arise between officials holding positions in different sections or departments of the enterprise. Where each man plays for his own hand instead of considering the interests of the business as a whole, efficiency is bound to suffer.

Objections on the part of employees.

The objections to amalgamations which have so far been mentioned have been those on the part of the *owners* of the businesses in question. Objections not infrequently emanate from employees of the businesses whose opinions on the subject may be very valuable; but if the latter are consulted in regard to contemplated mergers, it is necessary to consider whether, if the objectors are not disinterested, the objections are fair ones. The writer remembers a number of years ago being consulted in reference to a projected amalgamation of a number of Manufacturing Concerns. Several meetings of those owning or controlling the concerns in question were held, at which general approval was expressed of the main principles of an amalgamation scheme which was submitted. At a subsequent meeting at which matters of detail were gone into, the owners of the businesses, in a number of cases, were not present, their places being taken by Managing Directors or Managers. One of the clauses in the draft Scheme dealt with the question of compensation to be paid in certain cases to officials whose services, when the amalgamation took place, might not be required. Some of the suggestions made in this clause evidently did not commend themselves as being sufficiently generous to a number of the Managing Directors and Managers present, who obviously found difficulty in looking at the matter from the point of view of the owners of the businesses; and from the stage at which this clause was placed before the Conference a very noticeable lack of enthusiasm for the Scheme as a whole began to manifest itself. Each

of the representatives at the Conference presumably reported to his principals what transpired at the meeting and made his own comments on the Scheme. Finally, the Scheme was abandoned, as the interested parties who ultimately expressed themselves as in favour of it did not represent a sufficiently large proportion of the whole to warrant the amalgamation being proceeded with. To what extent the abandonment of the Scheme was influenced by objections which had their roots in personal matters, it is difficult to say ; undoubtedly, however, this factor entered into the case.

Comments on reductions of staffs necessitated or rendered expedient as a result of an amalgamation will be found in Chapter V.

Amalgamations engineered primarily for benefit of financial agents.

Before leaving the subject of objections to amalgamations, it may be appropriate to state that the public are often induced to subscribe capital on the occasion of the formation of a combine by the belief that an amalgamation is always automatically followed by considerable financial advantages to the businesses concerned.

It is therefore well for the prospective investor to form an idea as to whether the amalgamation originated as a result of a belief in the industry itself that improved benefits were to be secured thereby, or whether—as has been by no means uncommon in recent years—the idea of bringing the businesses together has not originated with some financial agent, with the sole object of obtaining for himself a commission, or remuneration in some other form, in connection with the merger. Such an one may induce the public, by means of the catch-word "amalgamation" to pay purchase-prices for the various businesses substantially in excess of their true worth, with the result that the combine is over-capitalised from its inception, and the unfortunate shareholders realise in due course that they have allowed themselves to be deceived.

CHAPTER IV

BRIEF DESCRIPTION OF THE MOST USUAL FORMS OF AMALGAMATION OR MERGER

THERE are a number of forms which mergers can take, as already indicated in Chapter I. Many of the considerations which arise, however, in connection with mergers, and many of the problems which have to be dealt with, are common to all or to most of the forms of merger. Broadly speaking, the forms of merger can be divided into the following three groups:

"Complete amalgamation."

(*a*) Where all the businesses or undertakings, as such, are placed under one ownership. This form of merger is not infrequently referred to as a "Complete Amalgamation".

"Holding company scheme."

(*b*) Where the community of interests is secured, not by merging the businesses as such, but by the acquisition of the whole of, or a controlling interest in, the Share Capital of one or more of the Limited Liability Companies owning the businesses in question. The shareholding in such a case is most usually acquired by a Limited Company and not by a firm or individual; and in consequence a scheme of merger on these lines is usually referred to as a "Holding Company Scheme".

"Pooling agreement."

(*c*) Where an agreement is entered into between the various interested parties which provides for the pooling of profits, either in whole or in part, for a series of years. In other words, the combined profits of the businesses would first be brought into a common fund and then

apportioned out in a certain ratio, or on a certain basis, defined in the agreement. A merging of interests on these lines is usually referred to under the name of a "Pooling Agreement".

Sales arrangements.

There are other arrangements having for their object co-operation or a partial unification of interests which do not fall strictly under the head of amalgamations. These may take the form of agreements between manufacturers for the maintenance of selling prices or for the limitation of geographical areas in which such Manufacturing Company or group of Manufacturing Companies is allowed to sell. Or they may go further than this and provide for the preservation, as between the interested parties, of certain proportions in regard to the quantity or the money value of the sales, any parties selling more than their quota or proportion of the whole being required to pay certain sums into a pool, which sums would be distributed among those parties who had sold less than their proportion of the whole. Again, these Sales Arrangements may go further still, and may embrace the formation of a separate Selling Company in which the various Manufacturing Companies would be interested in certain proportions. It would be the function of the Selling Company to take the whole of the products of the manufacturing businesses at certain prices and dispose of them, any profit made on the selling being distributed among the interested Manufacturing Companies.

Brief reference to arrangements such as the foregoing will be found in the Chapter on Pooling Agreements, *i.e.* Chapter VII.

It is now proposed to describe, in the following chapters, the chief distinctive features of each of the three chief classes of merger.

CHAPTER V

CONSIDERATIONS ARISING IN CONNECTION WITH A " COMPLETE AMALGAMATION ", *I.E.* A MERGER OF BUSINESSES OR UNDERTAKINGS AS SUCH

Introductory remarks.

BEFORE the parties who are contemplating a Complete Amalgamation of their businesses begin to consider any details, they should first assure themselves that, taking the circumstances as a whole, a " Complete Amalgamation " is the form of merger which has most to recommend it. The usual alternative to a Complete Amalgamation is what is known as a " Holding Company Scheme " whereunder, instead of a business being bought as such, for purposes of being merged with another, the whole of, or a controlling interest in, the Share Capital of a Limited Company owning a similar business is purchased.

A description of a merger by means of a Holding Company will be found in Chapter VI. ; and in a later part of this book (Chapter XIV.) will be found summarised the advantages and disadvantages attendant upon the various forms of merger. The present chapter deals only with a " Complete Amalgamation ", and it is not therefore appropriate to enter here, in detail, into the consideration of the advantages of a Holding Company Scheme. It may, however, be mentioned that the usual case in which a Holding Company Scheme offers the greater advantages, as compared with a scheme for a Complete Amalgamation, is where a business is owned by a Limited Company which has considerable Preference Share Capital bearing a low rate of dividend, and (or) a considerable long-term Debenture Capital to which a low rate of interest is attached. If the business owned

by such a Company were sold to another party, for purposes of a merger with another business, the Company would presumably go into liquidation and would distribute its assets among its Debenture-holders and Shareholders. When the Company had sold and had been paid for its business, its assets would consist of the consideration received for that business, and this consideration might be represented by cash, or, alternatively, by the shares of the Company which had purchased the business. As a result of the liquidation, the Company would presumably have to pay out its Debenture Holders and Preference Shareholders at par, or even at a premium (this depending respectively upon the provisions of the Debenture Trust Deed and of the Company's Memorandum and Articles of Association). If, however, such debentures and preference shares carried a low rate of income, their value in the market, assuming that no liquidation was in prospect, would presumably be much lower than the value which they would receive on the winding up. The point may be expressed in another way by saying that the benefit which such a Company enjoys by reason of its prior capital having been raised (presumably in pre-war times) at such low rates would, if a liquidation ensued, be lost. In effect, therefore, a liquidation would result in conferring an advantage on the Debenture-holders and Preference Shareholders at the expense of the Ordinary Shareholders. In such a case the obvious form of merger would be that the purchasing Company, instead of buying the business, should acquire the Ordinary Share Capital. By this means the Debentures and Preference Shares in question would be undisturbed, and the Ordinary Shareholders would receive a higher consideration.

Another advantage which a Holding Company Scheme possesses as compared with a Scheme of Complete Amalgamation is that it does not entail the trouble,

expense (and, not infrequently, the difficulties and risks) attaching to the transfer of assets and valuable contracts from the name of one Company to the name of another. Where such assets consist, for example, of Concessions and other rights in foreign countries, their transfer may vitiate or at least prejudice the beneficial interest in them which the Vendor Company possesses.

With the above few remarks in regard to the most common of the alternative forms of merger, it is now appropriate to pass on to consider the circumstances in connection with a " Complete Amalgamation ".

Alternatives of using existing company or forming new company.

The businesses or undertakings which are to be the subject of a complete amalgamation may be under the ownership of individuals, or firms, or Limited Companies. The tendency is for the owners of a business of any magnitude to form a Limited Liability Company to acquire such business, the owners holding the Share Capital of the Company. And in cases where amalgamations of businesses owned by individuals or firms take place, it is usual to provide that a Limited Company shall be the owner of the combined Undertaking.

The first question, therefore, which usually arises when a Complete Amalgamation of businesses is desired is whether a new Limited Company shall be formed to acquire the businesses, or whether, if one of the businesses is owned by an existing Company, that Company shall be enlarged and shall purchase the remaining business or businesses.

In an ordinary case it will probably be found most convenient and economical for the existing Company to purchase the remaining businesses. If a new Company were formed, expenses generally, incidental to its formation, will very likely be greater than if an existing Company, which already owns one of the businesses, is utilised to acquire the remaining businesses. In

this connection, however, attention is called to the special reliefs from duty on Share Capital and stamp duty on conveyance of assets, incidental to amalgamations, which are afforded by the Mining Industry Act 1926 and the Finance Acts 1927 and 1928 (see page 50 and Appendices E and F). Further, the legal and other formalities which would otherwise require to be carried through in connection with the sale of the assets of the existing Company, and the subsequent liquidation of that Company, would be avoided.

Other considerations may, however, be present which may make it preferable that a new Company should be formed. Before a decision is come to on this point, a careful review should be made of the circumstances of the existing Company—*e.g.* as to the rights attaching to its Share Capital (if there be more than one class of Capital); whether the shares are fully or only partly called up; the provisions of its Memorandum and Articles of Association; the basis on which its assets are brought into account for Balance Sheet purposes, etc. etc.

Payment for a business may either be in cash or in securities.

Bound up with this question is the question of whether the Company which is to buy the business, or businesses, is to make payment therefor in cash, or in the form of its own shares which would be specially issued for the purpose. If, for instance, its existing shares were worth less than their par value, a difficulty would arise in issuing further shares ranking *pari passu* with them, as a larger nominal amount of Share Capital would require to be issued than the real value of the business to be acquired; and although such an arrangement could probably be carried through (though in effect it would be tantamount to the issue of shares at a discount, which, strictly speaking, is illegal), the capital would in this respect be overstated or "watered", which is undesirable.

After points such as these have been considered, the

choice between forming a new Company or utilising an existing Company can be made.

In Appendix A will be found certain examples illustrating the circumstances under which the different alternatives would be adopted.

If an existing Company is utilised, such Company can, broadly speaking, pay for the other business, or businesses, in one of three ways:

(*a*) In cash, out of its surplus liquid resources, if any.

(*b*) In cash, obtained from an issue of fresh Share or Debenture Capital.

(*c*) In its own Shares or Debentures.

If the payment is made in cash, as would be the case under (*a*) or (*b*) above, it is of course only necessary, for purposes of the amalgamation, to arrive at the value of one business, *i.e.* the business for which the cash is being paid. If, however, payment is made in the form of the shares or debentures of an existing Company, as would be the case under (*c*), then it will be necessary to review also the affairs of that Company with the object of arriving at the fair value of the shares or debentures to be issued; and this not infrequently involves a valuation of the business of such purchasing Company.

Valuations of businesses for amalgamation purposes.

The first matter which engages the attention of the interested parties is that of the terms on which the amalgamation shall be carried out; in other words, the basis on which the values of the businesses shall be arrived at.

The value of a business at any date is, of course, represented by the excess of the total value of its assets over the total amount of its liabilities at such date. Speaking in general terms, the total of the liabilities of a business is a figure which can be accurately arrived at, the liabilities

Ascertainment of liabilities.

being matters of fact and not matters of opinion. It is true that there may be contingent Liabilities, and also liabilities the exact amount of which is doubtful, but this is the exception rather than the rule. A not uncommon practice is for each of the parties to an amalgamation to guarantee that the liabilities of their business at the date in question are exactly equal in total to the figure at which they appear in his Balance Sheet. If the figure is ultimately exceeded, then either the party can pay the difference in to the business, or, alternatively, the valuation of the business can be correspondingly reduced. Similarly, if the figure guaranteed is ultimately found to have been excessive, the owner can either draw the amount of the difference out of the business or, alternatively, the valuation of the business can be correspondingly increased.

Valuations of assets.

With regard to Assets, however, the values of these are, in a number of cases, matters not of fact but of opinion.

"Tangible" and "intangible" assets.

Assets may be divided into two categories—"tangible" and "intangible", tangible being, as the name implies, assets which can be seen, touched or handled, while intangible assets include rights or benefits, invisible, except to the mind, but none the less existent. Examples of intangible assets are the values residing in such things as Goodwill, Copyrights, Patents, etc.

Tangible Assets may be divided into Fixed Assets (such as Land, Buildings, Plant and Machinery) and Floating Assets (such as Cash, Book Debts and Stock-in-Trade).

In regard to the values of certain assets, practically no doubt can exist, as, for example, Cash at Bankers and In Hand, and Stocks and Shares having Stock Exchange quotations. As regards certain other Assets, as, for example, Book Debts and Stock-in-Trade, the degree of doubt as to the true value is, in the great majority of cases, very small, and little difficulty arises in making a valuation. But in regard to assets such as Land, Buildings and

Plant, the opinions of experts may differ widely as to what the real values may be, and this is even more true in regard to intangible assets, such as Goodwill.

Before, therefore, the parties to a projected amalgamation can arrange the details of a valuation of Assets and Liabilities, they must carefully consider and agree between themselves as to the general basis on which the valuations are to be made.

Parties to agree beforehand as to basis of valuations.

The Assets will, of course, require to be valued on the footing that they form part of a " going concern ", and not at the amounts which they would be expected to realise on being sold piecemeal. For example, two Manufacturing businesses engaged in a similar type of work and earning good profits may decide to amalgamate. The Works of each, on the basis of forming part of a going concern, may be of equal value ; the total " break up " value of the assets comprising the Works may, however, vary widely in each case, owing, perhaps, to the fact that the buildings in the one case can be utilised for other purposes by reason of their geographical position, whereas in the other case there might be little possibility of their being so used.

Assets to be valued on a "going concern" basis.

In the great majority of cases, where two businesses are to be merged and their relative values have to be arrived at, the broad basis of valuation which is fair for one business is fair also for the other. For example, in the case of the two Manufacturing businesses previously referred to, the Works and Plant of both could be valued by the same Valuer on exactly the same lines ; and the same remark would apply to the valuation of stocks of material in hand and work in progress. Further, the formula adopted for the valuation of goodwill could probably be similar in each case.

Under some circumstances, however, where two businesses or undertakings are merged, the basis of valuation which might be fair in one case might be quite inequitable

in the other, the difference lying in the nature of the businesses or undertakings. For example, amalgamations not infrequently occur between a business engaged in producing certain articles and a business engaged in selling similar articles, the combined business, in such a case, being known as a " chain " business. The circumstances in connection with the Manufacturing (or Producing) business on the one hand and the Selling business on the other may differ widely, and the method of computing the Goodwill of the one may be unsuitable in computing the Goodwill of the other.

Valuation of goodwill.

The chief difficulties in agreeing upon a satisfactory basis of valuation for purposes of amalgamations usually arise in connection with the ascertainment of the value of Goodwill. The question of Goodwill and the methods of valuing it will be found dealt with in a later chapter of this book; it is, however, necessary that a few general remarks on the subject should be made here, in order that certain main features regarding Goodwill may be kept clearly in mind.

Many definitions of Goodwill exist. To the mind of an Accountant the word " Goodwill " may, perhaps, be well described by saying that it represents the capitalised value of actual, or prospective, " super-earnings ". It is necessary to remember that a business may be earning profits and may yet have no Goodwill. If, for example, the profits which a business earns do not represent, and are not expected in the near future to represent, more than a fair commercial yield on the total values of the assets actually employed in that business (after deducting the liabilities), no goodwill can be said to exist.

The figure of earnings to be capitalised does not represent the whole of the earnings but merely what one may call the " super-earnings ", that is to say, those earnings in excess of the figure representing the fair commercial yield on the Capital employed in the business.

Assets as a rule only of value by reason of their earning power.

In considering these questions of "assets" and "earnings", it must be remembered that, with few exceptions, the values of "tangible" assets only exist because those assets are, or are expected to become, revenue-producing. (Among the exceptions may be quoted jewellery and works of art.) Some assets are approximately of the same value whether they are used in a particular business or not, as they can be detached and made effective use of elsewhere, as, for example, certain stocks-in-trade which can always command a fair cash price ; or loose Plant such as motor lorries, which can be used in many places and for many purposes. Other assets may, however, be of a certain value as part of a revenue-earning undertaking, but if that undertaking ceases to be remunerative, the assets may be of very much smaller value. As an instance there may be quoted Factory Buildings specially designed for particular manufacturing processes. If the particular process becomes unremunerative and the Factory is no longer used for the same purpose, its value, for purposes of other businesses, may, by comparison, be very small. To take a still more extreme case, one may instance the mains of a Gas Company, and the street paving and rails put down by a Tramway Company. In each of these two cases the assets have a certain value if forming part of a profitable undertaking ; but if the consumers of gas change over to electric light and the passengers who previously used the trams prefer to ride in motor omnibuses, there is obviously very little value left in the gas mains and the tram lines respectively.

Businesses may be valued by reference to assets or by reference to earning power.

These observations are intended to lead up to the following assertion, namely, that the extent to which the individual assets comprising a business should be valued as a means of arriving at the value of the business as a whole, and the extent to which the earning capacity of the business should be the guide to the value of that business, depend upon the nature and circumstances of the business.

An extreme case on the one hand is that of a business with floating assets only which can be detached and utilised profitably elsewhere. Such a case clearly demands that the value of the business should be arrived at by valuing the individual floating assets and then adding something (if justified) for "super" earning power, or, in other words, for goodwill. For instance, the assets of a Professional Accountant's business usually comprise:

(*a*) Office Furniture and Equipment;
(*b*) Book Debts and Work in Progress;
(*c*) Goodwill;

and each of these assets would be valued separately and the values aggregated for purposes of arriving at the value of such a business in connection with an amalgamation.

Extreme cases, on the other hand, are those of a Gas Undertaking or a Tramway or a Railway. Clearly in such cases the basis of valuing the Undertaking should be that of earnings only.

Parties to proposed amalgamation must be broad-minded in negotiations.

While dealing with the question of valuations of businesses in general for amalgamation purposes, the observation should be made that the parties interested must be prepared to deal with the matter, in negotiation, on broad lines if an agreement is to be reached. In other words, there must be a certain amount of give-and-take on both sides. If the question is approached on narrow lines, and each party makes up its mind beforehand to obtain the full pound of flesh to which it considers itself entitled, little progress is likely to be made. The spirit of compromise and a reasonable appreciation of, and consideration for, the views of others are essential if the negotiations are to fructify. ||

Various points which arise in connection with the valuations of different classes of assets—both tangible and

intangible—for amalgamation purposes will be found dealt with later in this book, in appropriate places. For the moment it is presumed that the stage has been reached when the *basis* of the valuation of the businesses has been agreed upon between the interested parties. It is then necessary for the parties to consider the date, or dates, as at which the valuations are to be made, and the date as from which the businesses are to be merged.

Date of valuations and date of merger.

Obviously, the valuations cannot be made as at a later date than that on which the businesses are to be merged, as the merger will presumably result in a number of the assets of each business being commingled, their identity and origin being consequently lost. The two dates need not, however, be the same. For example, a valuation of a business may be made as at 31st July for the purpose of that business being merged with another on, say, the subsequent 1st November. The value arrived at as at 31st July could be adjusted to some future date by adding to the total value a sum representing a certain percentage of that value, in order to make allowance for profits earned subsequent to the 31st July. At the same time, of course, a deduction would be made from the value as at 31st July in respect of any drawings of profits which had been made between that date and the subsequent date when the businesses were merged.

When the decisions have been come to as to the principles on which the valuation, or valuations, are to be made, the date as at which the valuations should be made can either be a past date or a future date. The choice in this connection depends entirely on the circumstances of the case.

For example, let it be presumed that a Company called the "X" Company agrees in, say, October to buy for cash the business of the "Y" Company with a view to that business being merged with its own as from the 1st December; and let it be assumed that the purchase price

is to be paid on the 1st February in the next year, together with interest on such purchase price as from the 1st December previous. And let it be assumed that it has been the practice of the "Y" Company to prepare its Balance Sheet annually as at 31st August, and that at the time when the agreement relating to the Amalgamation was reached, namely, in October, the audited Balance Sheet of the "Y" Company, dated the 31st August previous, was available. Two alternatives present themselves in regard to the valuation of the business of the "Y" Company. One alternative is that it should take place as at 31st August (*i.e.* at the date of the last Balance Sheet), and that there should be added to the value of the business arrived at as at that date a sum, at the rate of (say) 10 per cent per annum, in lieu of the profits of the period from the 1st September to the 30th November, less a sum representing the total amounts which the proprietors of the business have drawn, between these two dates, in respect of profits.

The other alternative is that the books of the "Y" Company should be specially balanced at the 30th November, and that the valuation of its business should be made as at that date. Clearly, the latter method would be the more accurate, in that it would result in the exact profits earned by the "Y" business between the 1st September and 30th November being ascertained and the "Y" business receiving credit therefor in the purchase price, whereas under the first alternative such profits would be treated as being equivalent to a percentage on the purchase price arrived at as at the 31st July, an assumption which must to a certain extent be arbitrary.

On the other hand, the preparation of a special Balance Sheet—entailing the balancing of the books and probably also the taking of stocks, etc.—involves a considerable amount of work which, under the first alternative, would be avoided.

The chief point influencing the decision between the two alternatives is frequently that of whether the information available in connection with the past Balance Sheet of the concern to be valued is sufficient to enable proper valuations of the fixed and floating assets to be made as at that date, or whether this information can only be ascertained as at some future date, special steps having to be taken for the purpose.

For example, in regard to stock-in-trade, a Company may have taken its inventories, for ordinary Balance Sheet purposes, on a somewhat conservative, though admittedly arbitrary, basis. It would be unfair that, by reason of this, the Company should be prejudiced as regards a valuation of assets for amalgamation purposes. Similarly, certain assets, such as Loose Tools, are not infrequently held up in the Balance Sheet of a business at some round figure which may be considerably smaller than the real value of such tools.

As regards Fixed Assets, such difficulties as these are not so likely to arise, as a valuer can appraise such assets at a particular date, and can then adjust his valuation back to the date of a past Balance Sheet by taking into account any assets acquired and assets demolished or disposed of between the two dates, proper evidence, of course, being made available to him in regard to such additions and demolitions or disposals.

It is perhaps appropriate to mention here that where a purchase price is arrived at by adding to the net value of the assets at a certain fixed date interest up to the date of the amalgamation (in lieu of profits earned between the two dates), the interest should logically be computed less income tax and not gross. The reason for this is that had the assets, less liabilities, of the business been valued as at the date of the amalgamation, instead of as at this previous date, the profits which would then have been included in the purchase price would be the profits

arrived at after reserving for income tax up to the date of the amalgamation.

Agreement, between the parties, as to basis of valuations.

Reference has been made to the agreement or understanding between the interested parties in regard to the basis on which valuations should be made. This does not, however, necessarily mean that the parties have bound themselves to accept the valuations, when made. In this connection two courses are open. One alternative is that the parties should definitely bind themselves, when they have agreed upon the basis, to accept the total of the valuations as subsequently ascertained, and to proceed with the amalgamation accordingly. The second alternative is that the parties should first arrive at an understanding as to the basis of the valuations, but should leave themselves free to accept or reject the totals, when finally ascertained, as representing the relative values of the respective businesses for amalgamation purposes.

The first of the two alternatives is, in practice, preferable. Sometimes, however, it presents difficulties.

If both the businesses to be merged have to be valued, then if the Land and Buildings are appraised in each case by the same valuer (and one valuer values the Plant in all cases) and the Stocks-in-Trade belonging to each business are likewise valued on the same basis, there is little probability that inequality of treatment should arise in respect of these assets as between one business and another, bearing in mind that if the valuation were considered to be unduly conservative in the one case, it would also presumably be correspondingly conservative in the other; the important point aimed for being not so much the actual but the *relative* values. If, however, one business alone requires to be valued (as would be the case if the other party to the amalgamation were to purchase it for cash), then it may be important that the general lines on which the valuer will make his

appraisal should be ascertained beforehand, as an unduly conservative valuation would prejudice the vendor, while, on the other hand, too high a valuation would injure the purchaser. Broadly speaking, however, it may be stated that in regard to "tangible" assets it should, as a general rule, be possible for the parties to satisfy themselves beforehand that the *basis* proposed to be adopted is a fair one, and to bind themselves to accept the amalgamation on that basis, before waiting to see the figures which ultimately emerge as a result of the valuations.

Basis for valuation of goodwill.

In regard to the valuation of goodwill, however, it may be difficult for the parties to agree upon a basis and bind themselves, as several important factors may be present in connection with the ascertainment of the value of goodwill which are difficult to assess and translate into figures.

For example, let it be assumed that two businesses are to be amalgamated on the basis of an independent valuation of their "tangible" assets at a certain date, and a valuation of Goodwill, based in each case on the profits of, say, the last five years.

Let it be assumed that in each case the "tangible" assets of the business, less liabilities, are valued at £100,000, and that the average annual profits of the last five years amount, in each case, to £20,000. Assuming for the moment that the character of each business was the same and that there were no exceptional circumstances which should be taken into account, it might be assumed, *prima facie*, that the value of the goodwill of each business should be identical. If, however, on enquiry it was found that while the average profits of the five years were, in each case, exactly the same, yet in the one case the profits showed a progressive increase and in the other case a continuous decline, the goodwill of the first business would presumably be more valuable than the goodwill of the second business. There are a number of other points which may conceivably require consideration in

connection with the valuation of goodwill, and the above example has been quoted merely as an illustration of the difficulties which arise in practice in attempting to lay down, in advance, a rigid basis.

From what has been said above, it is clear that, as a general rule, the parties to a prospective amalgamation would be unwise to bind themselves to accept a certain basis in regard to the valuation of goodwill unless they had, at least, been afforded an opportunity of reviewing each other's detailed Balance Sheets and Profit and Loss Accounts for a series of past years. If such a review has taken place, then it is probable that an acceptable basis could be found.

Valuation of goodwill by independent expert.

An alternative which is not infrequently adopted is for the parties to come to an agreement that the value of the goodwill shall be arrived at by an independent professional Accountant after reviewing the detailed Balance Sheets and Trading and Profit and Loss Accounts for a series of past years, and such other information as he may consider necessary: and that the value of goodwill, as arrived at by such Accountant, shall be adopted by both parties for amalgamation purposes. Coupled with this arrangement the parties occasionally make a stipulation to the effect that, in reviewing the facts and figures for the above purpose, the independent Accountant shall not consider the results of any financial period prior to a certain date.

Restrictions pending completion of negotiations.

While dealing with the agreement between the parties as to the basis of an amalgamation, it may be well to mention that it is necessary that, by agreement or understanding, certain restrictions should be placed upon the operations of the parties pending the amalgamation being carried through. For example, it may be necessary to stipulate that none of the parties shall in the meantime (*a*) increase its capital or issue debentures;

(*b*) make any distribution of assets or profits, or alternatively pay dividends in excess of a certain amount; (*c*) depart in any way from the usual methods of carrying on business, or enter into any exceptional, onerous or long-time contracts, without special approval of the other parties; (*d*) increase the amounts paid in respect of directors' remunerations, employees' salaries, etc., without similar special approval; (*e*) make changes in the directorate.

Consent of shareholders of a public Company to an amalgamation.

In connection with this question of the point at which the interested parties should be prepared to bind themselves to an amalgamation, it is appropriate to consider the position of a Public Company having a considerable number of shareholders. In such a case, the negotiations for the amalgamation must obviously be conducted by the Directors. In order to preserve proper secrecy, it is not possible for the Directors to acquaint the shareholders of the matter until it has approached a final stage: indeed, to do so would probably be prejudicial to the best interests of all parties. As a rule, the procedure is for the Directors to agree upon the terms of the amalgamation as being in their opinion fair, and to enter into an agreement with the other parties to the effect that they will recommend such terms to their shareholders for acceptance. In the great majority of cases, such an agreement is confirmed by the shareholders; at the same time, the action of the Directors has not bound the Company in any way, and the shareholders are perfectly free to reject the proposal which the Board has placed before them. As to how far Directors can legally or ought morally to bind a Company is a big question, and one which may have to be considered in particular cases.

Reductions in staffs as a result of an amalgamation.

The amalgamation of businesses not infrequently results in staff reductions consequent upon the administration (and sometimes also the actual operations) of the

concerns being centralised. Indeed, economies arising from such reductions might be one of the objects of the amalgamation. It is not usual, however, for old and valued servants of an Undertaking to be turned adrift in such circumstances if other courses of action are within the bounds of practical politics.

Any surplus of staff, in excess of the real requirements of the amalgamated concern, is a matter which gradually redresses itself by the reductions which normally take place from time to time as the result of resignations, deaths, etc. If, however, the financial needs of the undertaking really cannot justify so slow a process, then an alternative course is to dismiss certain of the staff, paying pensions to the elderly men and making money allowances to the younger men for a certain period pending their obtaining posts elsewhere.

It is not unusual for the proprietors of the smaller of two businesses which are amalgamating to make a stipulation with the owners of the larger business as to what the treatment of employees who have given long and valued service, but who may not require to be retained by the Combine, shall be. In the absence of such a stipulation, the treatment of such employees of the smaller business would, in reality, rest with the owners of the larger business, as the latter would presumably have the preponderating voting power in the new concern.

It will be appreciated that such pensions and allowances, if paid by the combined undertaking, form a burden on that undertaking for which it receives no benefit. If the charges which relate to each of the old businesses are in the same ratio as the values put upon such businesses for amalgamation purposes, then the matter will have been fairly treated as between one business and another—assuming for the moment that the interests of the two owners are to be represented by shares in a Limited Company which will own both businesses. If, however,

the charge is proportionately higher in the one case than in the other, some adjustment should, in equity, be made, such, for example, as by placing a lower value, for amalgamation purposes, upon the business in respect of which the relatively higher charge exists.

An alternative which naturally occurs to the mind is that each business should meet its own charges in this connection prior to the amalgamation, instead of allowing the burden to fall on the new Combine—in other words, that the net assets of each business should be depleted to that extent before being valued for amalgamation purposes. This is, of course, the most simple course, if practicable; and, in the case of pensions, it need present no difficulty, as a lump-sum payment can forthwith be paid to an Insurance Company, which would provide the annuities decided to be paid. Where, however, the businesses prefer to make the periodical pension payments themselves, and also where allowances are made to younger employees who have been discharged, pending their obtaining new posts, the exact amount of the total charge is an unknown quantity; and the most practical course is for an estimate to be made, in the case of each business, in the light of the best information available, and for the amounts of such estimate to be taken into account (*i.e.* to be treated as a liability) in fixing the respective values of the net assets of each business for amalgamation purposes. The combined undertaking would then meet the Liabilities as and when they became due.

New service agreements with officials.

While an Amalgamation may result in the services of certain members of the administrative staffs of the businesses being no longer required, it may also lead to added responsibilities being imposed on other officials: and where the past success of a business which is one of the parties to an amalgamation is found to be due, to an appreciable extent, to the services rendered by one or more

men in administrative posts, it is important that arrangements or understandings should be come to with such men, before the terms of the amalgamation are finally agreed, in regard to their responsibilities, duties and remuneration in the future—proper consideration being given, in fixing the scale or basis of remuneration, to any added responsibilities which the officials may be called upon to shoulder. It is to be borne in mind that the valuation of the goodwill of a business, for purposes of a merger, is, as a rule, based on the financial results of a series of past years. If, therefore, such financial results have, to a material extent, been due to the skilled services of one or two officials, and if those officials are at all likely to leave the service of that business when the amalgamation has been effected (or if they will in return have to be more highly remunerated), the value put upon the goodwill would require to be reconsidered, with a view to a possible reduction in the figure.

Restriction of competition by ex-owners and ex-managers.

While dealing with the question of the services of individuals to a business, the point should not be lost sight of that considerable damage to the future earning capacity of amalgamated businesses may arise if parties who have been active in the past, but whose services are no longer required in future, join a competing business. It is not unusual, therefore, to stipulate that those vendors of businesses which are acquired by the Combine who are not to be actively associated with the Combine in future shall not, for a certain defined period, engage in any competing businesses. And a similar stipulation would be made in regard to retiring officials who were compensated by pensions or by large lump-sum payments. In regard to this latter matter, in coming to a decision as to the form of the payment or payments, the question of Income Tax should be carefully considered both from the point of view of the official and also of the Company; and, in

connection with the official, the question of Sur Tax may also arise.

It may be well to mention here, while touching on the question of taxation, that it is very necessary that in considering the methods of carrying through an amalgamation and questions such as the liquidation of Vendor Companies the effect on the taxation position should be carefully reviewed. The parties concerned should be assured that matters are arranged on lines which minimise their liability to Income Tax and Sur Tax.

Income Tax and Sur Tax.

This Chapter has, so far, dealt in a general way with the following questions :

(*a*) The agreement as to the basis of a Complete Amalgamation ;

(*b*) the making of the valuation of the business, or businesses, in question ;

(*c*) the date from which the merger is to become effective ; and

(*d*) the stage at which the interested parties are to become bound.

As regards (*a*) and (*b*), which comprise questions incidental to the financial terms, these matters have only been commented on in a broad way, as it has been thought more convenient to deal with questions of general principle in one place and questions of detail in other places. The exact procedure necessary in this connection and numerous points which arise in practice will be found discussed and illustrated in considerable detail in other portions of this book.

It is now necessary to pass on to the stage at which the Complete Amalgamation is to be made effective. An agreement, it is presumed, has been signed whereunder a

Stage at which an amalgamation becomes effective.

Limited Company owning a certain business has undertaken to purchase, for a cash price stated or defined in the agreement, a business of similar character, with the object of combining it with its own.

(Alternatively, of course, a new Company may have been formed to purchase two or more existing businesses : and, again, the consideration may be paid in the shares or other securities of the purchasing Company instead of in cash. However, for the sake of simplicity, it will be assumed for the moment that an existing Company having sufficient cash resources has purchased, for cash, a business which is to be merged with its own.)

Stamp duties in connection with transfer of assets.

The necessary legal documents conveying the assets from the Vendor to the purchasing Company have to be drawn up and require to be signed at the time when the settlement takes place. In connection with assets which are not capable of manual delivery (as, for example, Land, Buildings, Book Debts, Goodwill), a Stamp Duty on transfer has ordinarily to be paid at the rate of 1 per cent on the value of the assets. With a view to minimising the stamp duty so payable, it is usual, in cases where the purchasing party takes over a business as a going concern, for the Deed to stipulate that there will be excepted from the sale such an amount of book debts (or other floating assets not capable of manual delivery and on which, therefore, stamp duty would otherwise be payable) as is equal to the amount of the Liabilities, and for the proceeds of the assets so excepted to be used by the Vendor to discharge such liabilities.

The charge in respect of these same duties has, in the past, had a detrimental effect upon amalgamation schemes. The Government has recognised this, and under recent legislation (namely the Mining Industry Act 1926 relating to Collieries and the Finance Acts 1927 and 1928 relating to Limited Companies working under the Companies Acts) certain reliefs are, in proper cases, provided

from such Stamp Duties and also from the duties on share and debenture capital of the purchasing company (referred to in a later paragraph of this Chapter). Extracts from these Acts will be found in Appendices E and F.

In an ordinary case of a sale of the property or other assets, the whole of the stamp duty on the Conveyance, or other Deed of Transfer, is payable by the purchaser. In the case, however, of a sale for purposes of an amalgamation, the parties usually agree between themselves beforehand as to how the expenses shall be borne, as it would probably be more equitable that these should be shared in ratio to the values of the respective businesses to be merged rather than that the Company which can most conveniently assume the rôle of purchaser, for the mutual benefit of both parties, should bear the whole of the stamp duty on the conveyance of the assets of the business which it is acquiring.

Capital duty on new share capital authorised.

In the case where the purchasing Company pays for the Vendor's business in cash out of the proceeds of Share Capital specially issued for the purpose, or in the case where the purchasing Company makes payment in the form of its own shares, capital duty (at the rate of 1 per cent) requires to be paid on the nominal value of the Share Capital so to be issued. If the purchasing Company has already created, but not previously issued, the Capital in question, then the capital duty will have been paid by it at the time of such creation. As in the case of the stamp duty on the Conveyance of assets, so also in regard to the capital duty on fresh Share Capital created, the proportions in which this burden should be borne by the respective parties is a matter for mutual arrangement.

Certain reliefs from these capital duties are, as already mentioned, provided in the Mining Industry Act 1926 and the Finance Acts 1927 and 1928, extracts from which Acts are to be found in Appendices E and F.

Capitalisation of Company owning or controlling the businesses.

Many interesting questions require consideration in regard to the Capitalisation of Limited Companies which become the owners of amalgamated businesses, either direct or through the holding of shares. These questions deserve, and will be found dealt with in, a separate Chapter—number XIII.

Continuity as regards distribution of profits.

A point which must not be overlooked in connection with mergers is the necessity for ensuring continuity in regard to drawings of profits (in the case of Private Firms) or dividend distributions (in the case of Limited Companies). No difficulty of this character arises where the amalgamated businesses are to be owned by an individual or by a Private Firm, as such parties can obviously draw money out of the business as and when they require it, irrespective of whether such drawings represent Capital or Profits. Where, however, a Limited Company owning a business purchases from an individual or a firm a similar business for amalgamation purposes, and issues, in payment for that business, its own shares, a legal difficulty as to the withdrawal of profits may arise. For example, a business owned by an individual may be purchased by a Limited Company (for amalgamation purposes) as at the 31st December, this being the date at which the annual Accounts of the Vendor's business have been usually drawn up. And the Limited Company may issue for that business its own shares to which might be attached dividend rights as from the following day, *i.e.* the 1st January in the next year. It may be that the Vendor has not been accustomed to draw out the bulk of each year's profits until the annual accounts of his business have been prepared. If such be the case, then he must arrange, in agreeing upon the terms of amalgamation, to withdraw whatever sum he needs in this connection in respect of the profits of the year ended the 31st December just prior to the date as at which the valuation is to take place, *i.e.* at 31st

December. Or, if he does not actually withdraw the sum in question before the end of the year, he should arrange that it should be treated as a liability of his business at 31st December for purposes of the amalgamation, and paid to him (with interest accruing from the 1st January) at some convenient date, or dates, in the New Year. In other words, the purchase price of the business, for amalgamation purposes, would be smaller by the sum so reserved.

If the Vendor has not withdrawn the profits, or arranged for them to be deducted in arriving at the purchase price with a view to his receiving them later from the Company in cash, he must be content to receive their equivalent in the form of the shares of the purchasing Company, that is to say, that they would form part of the assets of his business sold, and if he wishes to encash these profit she can only do so by selling the shares received in respect thereof.

An alternative arrangement could, of course, be made to the effect that the shares to be issued to the Vendor should carry dividend rights as from some past date, with the intent that immediately they have been issued a dividend should be declared upon them which would be calculated to give the Vendor, in cash, the sum which he desired. But it would not, or might not, be permissible to pay such dividend out of the accrued profits of the Vendor's business which the limited Company had taken over (it could, however, be paid out of any other undistributed profits which the limited Company had available). In other words, the mere fact that among the assets taken over and paid for by the Limited Company at a certain date are included Assets representing undistributed profits of the Vendor's business does not, of itself, make such assets legally available to the Limited Company for distribution by it in dividend.

It will be appreciated, of course, that a higher value

would require to be attributed to the shares of the purchasing Company if these were to carry dividend rates as from some prior date than if such rights merely accrued from the date of the issue of the shares.

Sur tax liability in connection with distribution of profits.

In connection with cash distributions of a vendor company to its shareholders at or about the time of the amalgamation the following point should be borne in mind.

If the distribution is made before the vendor company actually goes into liquidation, and is out of accumulated profits, then of course the recipients, if sur tax payers, will have to bring the dividend in question into their sur tax returns. But if matters incidental to the amalgamation are so arranged that the distribution is made after the vendor company has gone into liquidation, then the payments in question are not deemed to be the income of the recipients for sur tax purposes, as they merely form part of the distribution of the whole of the net assets of the vendor company by the liquidator, and in such a case no discrimination exists between monies which represent capital originally subscribed by the shareholders, and monies which represent accumulated undistributed profits.

It is, however, necessary to mention here that in certain cases where the control of a Company is in a few hands the Inland Revenue Authorities have the power (under certain circumstances) to tax such of the Shareholders as are Sur Tax payers on their proportion of the profits earned, and not merely on their proportion of the total dividend distributed. And the Authorities have the right, in such cases, to collect the tax through the medium of the Company itself. It is therefore necessary for the Liquidator of such a Company to take steps to assure himself, before he distributes the assets in the liquidation, that no such claim by the Inland Revenue is pending.

When once the consideration for any business or businesses to be purchased in connection with an Amalgamation has been paid, or agreed to be paid, and the date as from which the merger is to become effective has arrived, the businesses can be treated for all purposes as one. There is no longer any need to discriminate between, or to keep separate, the assets of the one or the other, as all are henceforth under one ownership. Nor would any division require to be drawn between the earnings of one and the earnings of the other. Similarly, employees—administrative staffs, clerical staffs and workpeople—can be commingled.

Point at which the merger of the businesses takes place.

Certain legal formalities may require to be complied with in advance of the merger, *i.e.* the transfer of contracts of various kinds (such as, for example, service contracts) from the name of the old Vendor business to the name of the new concern ; and similar steps will require to be taken in regard to the registration of trade names, patents, copyrights, etc. It is unusual for any serious difficulties to arise in this connection ; at the same time, it is very necessary that the position in regard to matters such as these should be carefully reviewed before the final agreement to amalgamate is reached, in order that the parties may be quite sure that no real difficulties are likely to be met. In this connection, the services of legal advisers will, in all probability, be needed.

Legal formalities and legal work.

There are, of course, a number of other matters in connection with Amalgamations—no matter what the form of merger may be—in regard to which the services of Solicitors are essential ; and parties to an amalgamation would, as a rule, be ill advised to proceed very far without acquainting their legal advisers of the position and keeping the latter in touch with the developments as they occur.

In cases where the ownership of the merged businesses

or undertakings is to rest with a Limited Company which is already in existence, it is very necessary that the Memorandum and Articles of Association of that Company should be carefully scrutinised, in order to see whether any of the provisions included therein require amendment, bearing in mind the new responsibilities which the Company will be required to assume and the altered circumstances generally. In particular, it may be found that the Objects Clause of the Memorandum of Association of the existing Company (that is to say, the clause which defines the character and scope of the business which the Company is entitled to undertake) may require enlargement: and, again, it is not infrequently the case that the Articles of Association of a comparatively small Limited Company which has been formed some long time ago are, in a number of respects, antiquated and quite unsuited to the requirements of a large and up-to-date organisation. As will be appreciated, these matters are eminently of a legal character, and the writer is not competent, nor has he attempted, to particularise in regard to them.

Where the owner of a business to be merged receives payment for that business in cash, the regulations governing the purchasing Company will have no interest for him; where, however, he is to receive payment in whole or in part in the shares of such Company, then it is vital that, in addition to being assured that the consideration which he is receiving for the sale of his business is a fair one, he should be satisfied that the rules and regulations under which the Directors of the Company will administer the business of that Company, as agents for the shareholders, of which he is one, should be fair and suitable.

It is not suggested that all questions incidental to the constitution of a purchasing Company should be left to the discretion of the legal advisers to the various inter-

ested parties ; it is very necessary that the parties themselves should study and understand the documents before they are finally approved and become binding. Questions of phraseology must admittedly be left to lawyers, but the latter would not have intimate knowledge of the circumstances and conditions of the businesses which those who administer such businesses must possess.

While touching on legal matters, it may be advisable to mention that, in the eyes of certain business men who have not much acquaintance with the law and its ways, the impression prevails that " one Solicitor is as good as another ", and that, so long as the services of a duly qualified Solicitor are requisitioned, the choice of the particular man matters little. It is, however, necessary to remember that the law has many branches, and that it is practically impossible for an individual to amass exceptional experience in all those branches. As in every profession, a certain amount of specialisation is essential if a high standard of excellence in any particular direction is to be attained. It follows that in connection with amalgamations, and particularly where Limited Companies are concerned, it is very advisable that the parties should be guided by solicitors who have had wide experience in Company matters and a reasonable amount of experience of amalgamations. The writer is speaking here from personal experience. He has been concerned with amalgamations in which the skill of Solicitors specially versed in this class of work has been of invaluable service to the clients. On the other hand, he has had knowledge of cases where the disadvantages of employing Solicitors with little Company Law experience and no knowledge of amalgamation work have been only too apparent.

It is not suggested that as soon as an amalgamation seems a possibility, each party concerned should necessarily dispense with the services of the legal advisers whom

he usually employs in business matters, and entrust the drawing up of all the documents in connection with the amalgamation to some other firm of Solicitors. A large part of the legal work will be of a comparatively simple and straightforward character, demanding care, but not exceptional experience; and satisfactory arrangements may be come to whereunder the "General Practitioner" and the "Specialist" can work in conjunction. The latter would review the situation as a whole; he would recommend the course of action; and he would consider, and pass, the more important documents. The former would undertake that part of the work which was of a more routine character.

Steps taken to obtain benefits of merger.

As soon as a merger is an accomplished fact, steps can be taken with a view to reaping the benefits anticipated to result from it. If the writer may venture to offer a word of advice to any interested parties in this connection, it is that they should not be in too great a hurry to make changes, but should take ample time to acquaint themselves thoroughly with the circumstances regarding the business, or businesses, of which they have not, so far, had experience. In particular, it is important that they should give themselves full opportunities of judging the characters and capabilities of the principal employees. If hasty steps are taken which are afterwards found to have been ill advised, much damage may be done. An atmosphere of unrest and uncertainty may be created, the sympathies of loyal workers may be alienated, and valuable goodwill (using the term both in the financial and also the ethical sense) may be lost.

Summary of advantages and disadvantages of various forms of merger.

As already mentioned, a summary of the advantages and disadvantages of various forms of merger will be found in a later part of this book (Chapter XIV.).

CHAPTER VI

CIRCUMSTANCES ARISING IN CONNECTION WITH A "HOLDING COMPANY SCHEME"—*I.E.* A MERGER BY MEANS OF THE ACQUISITION OF SHARES IN A LIMITED COMPANY

Introductory remarks.

As already explained, a "Holding Company Scheme" does not result in businesses, as such, being amalgamated ; it merely provides for a community of interests. In other words, by making the ownership of the businesses identical (or largely identical) it ensures the businesses being carried on in a spirit of co-operation, instead of in competition ; it implies a pooling of brain power ; and it secures, in the main, the same results as would have been attained by a complete fusion of the businesses as such.

There is nothing to prevent an individual (or a private firm) owning a business from acquiring the whole of, or a controlling interest in, the Share Capital of a Company owning a similar business, and so unifying the interests of both businesses. At the same time, by far the most usual procedure is for the controlling entity to be a Limited Company and not an individual or a firm, by reason of the many benefits which ownership by means of a Limited Liability Company confers. It will consequently be assumed in this chapter that a Limited Company, and not a firm or an individual, is the controlling entity.

Choice of new Company or an existing Company as the Holding Company.

The first question which presents itself in the case of a Holding Company Scheme is whether a fresh Company altogether shall be formed to acquire the shares in question, or whether a Company already formed and owning

one of the existing businesses shall be utilised and shall purchase the whole of, or a controlling interest in, the Share Capital of the Company or Companies owning the other businesses.

The answer to this question depends entirely on the circumstances of each case.

Advantages of utilising an existing Company.

One obvious advantage of utilising an existing Company is that of economy in the expenses incidental to the merger. If a new Company be formed there are certain expenses incidental to its formation which would be saved if one of the existing Companies is used.

In an ordinary case, on the formation of a new Company and the acquisition by it of shares, duties have to be paid, namely, a duty at the rate of 1 per cent on the Authorised Share Capital, and duty at the rate of 1 per cent on the transfer to that Company of the securities in question. While commenting on duties in connection with Capital, it may be mentioned, in regard to Debenture Capital, that in respect of Registered Debentures the duty is 2s. 6d. per cent and in respect of Debentures to bearer it is £2 per cent. Where, however, these steps are taken incidental to an amalgamation, reliefs from these duties can, under certain circumstances, be obtained. These reliefs are given under the Mining Industry Act 1926 (relating to Collieries) and under the Finance Act 1927 and the Finance Act 1928 (relating to limited Companies working under the Companies Acts). The appropriate sections of these Acts will be found set out in Appendices E and F.

Advantages of forming a new Company.

Expense, however, is by no means the only consideration. There may be quite a number of circumstances which make it preferable that a new Company should be formed to hold the shares of the Companies owning the businesses concerned. In the first place, there is the question of sentiment. The shareholders in a Company whose shares are to be bought by an existing Company owning

a similar business occasionally feel that such an arrangement may savour, in the eyes of the business world, of the absorption of a less important by a more important entity. Where, however, the shares are paid for by the Holding Company in its own shares instead of in cash, the shareholders in question automatically become shareholders in the Holding Company and have a proportionate voice in the direction of the affairs of that Company. And where the Holding Company pays for the shares in cash, the shareholders in the other Company can have no valid objection to the form of the merger, seeing that they will, in future, have no interest in the shares, or the affairs, of either Company, as, having taken their payment in cash, they disappear from the scene.

Again, the formation of an entirely new Company, and the arrangement of its capitalisation on lines which render subsequent expansion easy, is calculated to facilitate the admission from time to time of additional businesses to the combine. In other words, the parties owning the businesses in question would sell their ordinary Share Capital to the Holding Company in exchange for additional Share Capital which the latter Company would issue.

Another and a more real objection to the utilisation of an existing Company as a Holding Company may be founded on the grounds of future finance. If, for example, an existing Company, which it may otherwise be desirable to utilise as a Holding Company, has a considerable debenture debt outstanding, the purchase by that Company, in exchange for the issue of further Share Capital by it, of the Share Capital of another Company has more than one possible disadvantage. In the first place, if the business of the Holding Company were to fall upon evil days and the Debenture Holders appointed a Receiver, the shareholding in the other Company might have to be realised on the footing of a forced sale, in common with

the other assets of the Holding Company. In this way both businesses might pass into entirely new hands, and the original owners might receive nothing at all in respect of their interest therein. If, on the other hand, a new Holding Company were formed to acquire the shares of both existing Companies, the debenture holders in question, while bringing the one Operating Company to its knees, could not interfere with the business or the assets of the other Operating Company.

Again, it is frequently found convenient that any additional Capital which the Operating Companies may need for their businesses should be found by the Holding Company by means of the latter Company making an issue of its shares or debentures for cash and loaning the proceeds to the Operating Companies. The Holding Company might be in a more favourable position to raise such Capital economically if it were a new Company, and therefore unencumbered with any liabilities, than if it were an old Company with a large debenture issue.

What is true in regard to Debentures is, broadly speaking, true also in regard to Preference Shares. Briefly, the point is that there is no object to be gained in improving the security of existing prior Capital, such as Debenture or Preference Share Capital. Any improvement in the security for such Capital must imply some corresponding sacrifice or relinquishment of security on the part of the Capital ranking behind, *i.e.* the Ordinary Share Capital; and the object of the Holding Company Scheme is to strengthen and improve the position of the Shareholders having the control of the Companies in question, that is to say, in the great majority of cases, the Ordinary Shareholders.

Speaking, therefore, in general terms, it may be said that if one of the Operating Companies has considerable prior Capital while the other has not, it is the latter Company which, *prima facie*, should be chosen as the Holding

Company. If, however, both of the Operating Companies have heavy prior charges, then it will probably be thought preferable to form a new Company to hold the controlling interest in the Share Capital of each operating Company, in order that the security behind the prior Capital of one of the operating Companies should not be strengthened to the possible detriment of the real parties to the merger, *i.e.* the Ordinary Shareholders.

Possible importance of secrecy

Another possible advantage in the formation of a new Holding Company is that of comparative secrecy.

The two operating Companies may be public Companies having a large number of Preference Shareholders, while the Ordinary Shares may, in each case, be held by comparatively few people, as for example by the members of the families which founded the businesses. If, in such a case, one of the operating Companies were made the Holding Company, the Preference Shareholders of that Company would receive, yearly, a Balance Sheet in which the holding in the other Company appeared, and they would probably expect to receive a certain amount of information as to the affairs of that Company. Further, the fact would thus be widely and periodically advertised (which might not be altogether desirable) that the interests of the two businesses were really one, and that such businesses were being operated in unison, instead of in competition with each other. If, however, a new Holding Company were formed to acquire the Ordinary Share Capital of both Operating Companies, the owners of the Share Capital of that Company might be comparatively few in number; correspondingly fewer Balance Sheets would be circulated; and little publicity would attach to the annual meetings of that Company. Further, the Holding Company might bear a name which would be unlike the names of either of the existing Companies, which latter names might, perhaps, be household words

in the particular trade or industry concerned. If the shareholders of the Holding Company, exclusive of the employees of that Company, number less than fifty, the Company could be a Private Limited Company, in which case it would not be under the necessity of filing a Balance Sheet at Somerset House which would be available for public inspection, as are the Balance Sheets of Public Limited Companies.

Holding Company may acquire shares for cash, or may issue its own securities as the consideration.

In addition to the question of whether a new Company shall be formed to acquire the shares in both Operating Companies, or whether one of the Operating Companies shall be utilised as a Holding Company to acquire the shares in the other Operating Company, there is also to be considered, at the earliest stage, the question of whether the Holding Company shall acquire the shares for cash or whether it shall pay for them in the form of its own shares.

Naturally, the answer to the above question depends upon the wishes of the parties to whom the consideration is to be paid. Such parties may desire to continue their interest in the Combine, in which case they will wish to be paid in the shares of the Holding Company. On the other hand, they may be desirous of relinquishing their interest altogether, in which circumstances they would require to be paid in cash. There may, of course, be alternative courses, and combinations of the two sets of circumstances—as, for example, where the parties are willing to take part of the consideration in the form of the Ordinary Shares in the Holding Company and part in the form of cash ; or, again, where they may prefer to take a part of the consideration in cash and the remainder in some prior security of the Holding Company, *i.e.* Debentures or Preference Shares.

Upon the answer to the above question may possibly depend the answer to the question already discussed, *i.e.* the alternative of forming a new Holding Company, or

utilising an existing Company ; as, if the Holding Company is to make an immediate issue of Capital for cash, the better the security it can offer, the better the terms upon which it can obtain such Capital.

If the Holding Company is to pay in cash for the shares which it is to acquire, then it can do so either (*a*) by utilising any surplus Floating Capital which it may possess, or (*b*) by making an issue of further Capital for cash and paying for the shares out of the proceeds of such issue. Alternative (*a*) would presumably only occur in the case of an existing Company being utilised as a Holding Company ; alternative (*b*), however, might occur in both cases, that is to say, that the issue of Capital for Cash could either be made by a new Holding Company, or it could be made by an existing Operating Company which would be utilised as a Holding Company.

In the case of an existing Operating Company being utilised as a Holding Company and acquiring for cash the shares in the other Operating Company, the amalgamation would only involve the valuation of one interest, *i.e.* the shares to be bought. If, however, a new Holding Company is to be formed to acquire (either for cash or in exchange for its own shares) the Ordinary Shares of two Operating Companies, then both the interests concerned will obviously require to be valued ; and similarly, where an existing Operating Company is utilised as a Holding Company which acquires, in exchange for an issue of its own shares, the shares of another Operating Company, both classes of shares would be valued.

Principles on which a valuation of shares is made.

The general considerations incidental to the valuation of a business or undertaking, as such, have already been referred to in Chapter V. in connection with a " Complete Amalgamation " ; and these considerations also apply in regard to the valuation of the shares of a Limited Company owning such a business or undertaking. In other

words, it follows, in an ordinary case, that if a business, as such, is worth £x, the whole of the Capital of a Limited Company owning such a business must also be worth £x.

It may be, of course, that a person purchasing a business owned by a private individual might give slightly less for that business than if it were owned by a Limited Company (and the purchase consequently related to the Share Capital of the Company and not to the individual assets of the business as such), as the purchaser might set some value on the advantages conferred by ownership by means of a Limited Liability Company. This consideration is not, however, one which need be discussed here. The broad principle remains that the total intrinsic value of the Share and Debenture Capital of a Limited Company owning a business is equivalent to the value of that business as a going concern.

Holding Company usually owns ordinary shares.

In the great majority of Holding Company Schemes, however, the Holding Company does not acquire the whole of the capital of the other Company, or Companies, but merely the whole of, or a controlling interest in, the Ordinary Share Capital. Indeed, as has already been mentioned, one of the chief reasons for the choice of a Holding Company Scheme in preference to other forms of merger is that it enables the Company or Companies concerned to leave undisturbed Debenture and Preference Issues which have been raised at low rates of interest or dividend, and so to retain the use of the Capital which has been obtained on what, under present-day conditions, may be regarded as exceptionally cheap terms. It is therefore necessary in such cases to arrive firstly at the value of the business of the Company as such, and then to deduct from such value the value represenfed by any Debenture or Preference Share Issues, with a view to computing, by this means, the value of the Ordinary Share Capital.

Basis of valuing ordinary shares where prior issues also exist.

In this connection it is necessary to remember that the value to be deducted in respect of such prior Capital is not necessarily the nominal value, but the true value. It may be that, on a liquidation, such prior Capital has the right to be repaid at par, or even at a premium. If, however, the possibility of liquidation is so remote as to be negligible, and the prior Capital only carries a comparatively low rate of interest or dividend, its value, as between a willing buyer and a willing seller, may be very much less than par. The fact that this prior Capital has been raised on such favourable terms means that a smaller proportion of the total profits of the Company is absorbed by prior charges than would otherwise be the case: a larger proportion is therefore available for dividend on the Ordinary Share Capital, and, consequently, the Ordinary Share Capital is correspondingly more valuable.

The example set out below will illustrate the foregoing principle:

Let it be assumed that two Companies own businesses exactly similar in character, in assets and in earning capacity, and that the value of each business is correctly reflected by the following figures:

Fixed Assets	£100,000
Floating Assets	30,000
Goodwill	30,000
	£160,000
Deduct Liabilities	10,000
Net Assets, including Goodwill	£150,000
Average Trading Profits, say	£14,000

Let it be assumed that one business is owned by a Limited Company which was formed in pre-war days and has a Capital constituted as follows:

4% Perpetual Debentures (redeemable at par in the event of a liquidation)	£40,000
5½% Cumulative Preference Capital (repayable at par on a liquidation in priority to the Ordinary Capital)	40,000
Ordinary Share Capital	70,000
	£150,000

Let it be assumed that the second business is owned by a Limited Company formed in post-war days and having a Capital as follows :

5½% Perpetual Debentures (redeemable at par in the event of a liquidation)	£40,000
8% Cumulative Preference Capital (repayable at par on a liquidation in priority to the Ordinary Capital)	40,000
Ordinary Share Capital	70,000
	£150,000

If each Company were to sell its business for cash at a purchase price equivalent to the book value of the net assets, and then were to go into liquidation, the Debenture Capital, the Preference Share Capital and the Ordinary Share Capital in each case would be paid off at its nominal value (ignoring the question of the expenses incidental to the liquidation).

If, however, no liquidation were contemplated, the values of the different classes of Share Capital would be very different.

In the case of the first-mentioned Company :

The real value of the £40,000 4% Perpetual Debentures might be considered to be about 75% of the nominal value, or, say	£30,000

The real value of the £40,000 5½% Preference Share Capital might be about 70% of the nominal value, or, say	28,000
	£58,000
As the value of the business as a whole is assumed to be	150,000
This would leave as the value of the Ordinary Share Capital the sum of	£92,000

In the case of the second-named Company :

The value of the £40,000 5½% Perpetual Debentures might be considered to be about par, namely	£40,000
The same remark would apply to the £40,000 8% Cumulative Preference Share Capital . . .	40,000
	£80,000
The value of the business as a whole being assumed to be	150,000
There would remain, as representing the Ordinary Share Capital, a value of	£70,000

The fact, therefore, that the first-mentioned Company had been able to raise its prior Capital more cheaply than the second Company means that its Ordinary Share Capital should be worth, on the basis of the Company continuing to carry on the business as a going concern, £92,000, as compared with the value of £70,000 attributed to the Ordinary Share Capital of the second Company.

A proof of the reality of this increased valuation is seen by a comparison of the profits available for dividend on the Ordinary Share Capital in the case of each Company.

As regards the *first* Company :

The Interest on £40,000 4% Debentures absorbs .	£1,600
The Dividend on £40,000 5½% Preference Share Capital absorbs	2,200
	£3,800
The total net Trading Profits have been assumed to be	14,000
There is therefore available for dividend on the Ordinary Share Capital (£70,000) and for General Reserve the sum of	£10,200

As the Ordinary Capital has been valued, as stated above, at £92,000, the sum available will permit the payment of a dividend representing just over 11 per cent on that value, assuming that the profits were wholly distributed and that nothing was appropriated to General Reserve.

In the case of the *second* Company:

The Interest on £40,000 5½% Debentures would absorb	£2,200
The Dividend on £40,000 8% Preference Share Capital would absorb	3,200
	£5,400
The net Trading Profits have been assumed to be	14,000
There would therefore be available for a dividend on the Ordinary Share Capital and for appropriation to General Reserve the sum of . .	£8,600

As the Ordinary Share Capital of this Company has been assumed to be worth exactly its par value, namely, £70,000, the sum of £8600, if wholly paid away in dividend, would represent a distribution on such value at the rate of slightly over 12 per cent, as compared with a distribution of just over 11 per cent on the value arrived at in the case of the first-mentioned Company.

Broadly speaking, therefore, the values attributed to the Ordinary Share Capital in each case are seen to be justified. The question may be raised as to why a yield is shown in the one case of slightly over 12 per cent, whereas in the other case the yield is slightly over 11 per cent. The answer to this question is that an Ordinary Shareholder in the first-mentioned Company would be content with a slightly lower yield on the market value of his shares than would an Ordinary Shareholder in the second Company, as the security for the maintenance of the dividend is slightly better in the first than in the second case. As will be seen from the figures, only £3800 out of the profits of £14,000 is absorbed by prior charges in the case of the first-named Company, whereas in the second-named Company £5400 out of £14,000 is so absorbed.

Holding Company has power to divert profits from one operating Company to another.

It will be appreciated that where a Holding Company owns a controlling interest in the Share Capital of two operating Companies, or, alternatively, where one of two operating Companies acts also as a Holding Company by owning a controlling interest in the Share Capital of another operating Company, the Holding Company, by virtually controlling both businesses, has it in its power so to arrange matters as to divert profits from one business to another: and, in fact, Holding Companies do, in a considerable number of cases, thus influence the conduct of the businesses to the detriment of one business and the advantage of the other, the object being, of course, the good of the businesses considered together. Similarly, Holding Companies not infrequently take steps which result in the values of the assets of one business being improved and the values of the assets of the other business being depreciated—the objective being, as before, the benefit of the undertakings as a whole.

Many examples of such steps will occur to the mind. For instance, where the businesses in question live, to a considerable extent, by advertisement, the advertising campaign would be specially "pushed" in the case of the business where the results anticipated therefrom would be expected to be most satisfactory; while the advertising expenditure, in the case of the other business, might be reduced, with the result that the profits of such latter business might show a very considerable falling off. Then again, one business may own up-to-date Plant and Machinery, whereas the other may own Plant and Machinery of an earlier, and less efficient, type. It may be beneficial, from the point of view of the two undertakings considered as a whole, to employ the efficient plant at its fullest capacity and to keep it in thorough working order, and merely to use the less efficient plant in times of exceptional pressure. The efficient plant would, therefore, presumably be helping to earn good profits for the one business, whereas the less efficient plant, being only partly used, would be of comparatively little value to the second business. Similarly, the manufacturing processes would be concentrated in the most up-to-date and efficient Factories or Works, while those Works which were of a more inconvenient or antiquated type might merely be utilised for storage and similar auxiliary purposes.

Outside shareholders' interests to be safeguarded.

No objection can, of course, be taken to procedure such as that described above, assuming that no outside interests have to be considered. Where, however, the Holding Company does not own the whole of the Share Capital of the Operating Company, but merely a controlling interest therein, the Directors have a duty to the holders of the remaining portion of the Share Capital, such duty being to see that no steps are taken which, though of advantage to the businesses considered as a whole, are yet prejudicial to the outside Shareholders, who are only interested in the one business.

For example, where the Holding Company owns the whole of the Ordinary Share Capital of the Operating Companies, but where the latter have prior securities, such as Debenture Capital and Preference Share Capital which are in other hands, the position of such Debenture Holders and Preference Shareholders must not be prejudiced by any co-operative arrangements between the two or more Companies concerned.

Means of safeguarding outside interests.

One means of safeguarding the interests of prior security holders is for the Holding Company to guarantee the payment of the Debenture Interest, and, in the case of the winding up, the repayment of the principal out of any available assets owned by it; and, similarly, to guarantee the payment of the dividends on the Preference Share Capital of the Operating Companies out of any available profits in its hands. Coupled with the latter stipulation should be the proviso that the Holding Company should, if circumstances so necessitate, require the Operating Companies to distribute in dividend (in cash or in kind) any free reserves in their hands which had accumulated since the Holding Company had acquired their shares. In default of such a stipulation, it would be possible for the Holding Company, by preventing the operating Companies from declaring any dividend on their Ordinary Share Capital, so to arrange matters that no free reserves ever remained in its hands available for distribution as dividend.

Where, however, the Holding Company does not own the whole of the Ordinary Share Capital of an Operating Company, the question, from the practical point of view, becomes more difficult, and it is very important that the Directors of that Operating Company should not, at the instigation of the Board of the Holding Company, take any step or pursue any policy which would render them liable to be proceeded against by the "outside" ordinary shareholders of such Operating Company.

Voting rights of Preference Shareholders in Operating Companies.

In connection with the Preference Share Issues of Operating Companies, it is necessary that before a Holding Company Scheme is decided upon, the position of such Preference Shares as to voting should be carefully considered. In the great majority of cases the capitalisation of an Operating Company is so arranged that the voting control rests with the Ordinary Shareholders and not with the Preference Shareholders; indeed, it is not infrequently the case that the Preference Shares, so long as the fixed dividends are being promptly paid thereon, do not carry votes at General Meetings of the Company. Where, however, the Preference dividend is not being paid it is usual for the Preference Shares to carry votes, and the extent of this voting capacity requires to be considered in its possible future effect on the Holding Company Scheme.

It is possible to contemplate circumstances whereunder a Holding Company which owns, say, 60 per cent of the Ordinary Share Capital of an Operating Company which has also Preference Share Capital, may be able to exercise full control so long as the fixed dividend on such Preference Capital is being regularly paid. If, however, the Operating Company found itself unable to continue the payment of the preferential dividend, then the Preference Shareholders, by combining with the 40 per cent of the Ordinary Shareholders, might outvote the holder of the 60 per cent interest in the Ordinary Share Capital, *i.e.* the Holding Company. In such circumstances the control previously held by the latter might be seriously impaired, if not altogether lost.

Voting control of a Company possible although majority interest not held.

An interesting point in connection with the ownership or control of businesses by means of a Holding Company is that matters can, under certain circumstances, be so arranged as to give one of several parties the control over all the businesses concerned, although the value of that

party's interest may be smaller than the total value of the interests of the other parties.

For example, a Mr. X may hold 75 per cent of the Share Capital of a Company (called "A"), whose interests are to be unified with those of another Company (called "B"), with a view to the businesses owned by the two Companies being worked in harmony and co-operation.

The business of the "A" Company might be valued at, say, £100,000, and the business of the "B" Company at, say, £90,000.

Mr. X's interest being worth £75,000 (namely, 75 per cent of £100,000) is therefore less than one-half of the value of the two businesses taken as a whole, *i.e.* £190,000; and if both businesses are sold to a new Company which would issue its own shares as payment therefor, and if the two old Companies were thereupon wound up and consequently distributed these shares among their own shareholders, Mr. X would only possess 75/190ths of the total issued Capital of the new Company, *i.e.* considerably less than one-half. He would not, therefore, enjoy control.

Similarly, if a new Company were formed to buy from the individual shareholders of each existing Company their shares and to pay for these shares in the form of its own shares, Mr. X would possess just the same fraction of the issued Share Capital of the new Company, *i.e.* 75/190ths, or less than one-half.

But if the new Company purchased both the businesses and issued its own shares in payment therefor, and Company "A" did *not* go into liquidation and distribute its portion of such shares among its own shareholders, the position of Mr. X would be very much stronger. Company "A", by owning £100,000 out of £190,000 of the Share Capital of the New Company, would have the control of that Company; and Mr. X,

by owning 75 per cent of the Share Capital of Company "A", would have the control of this latter Company. Indirectly, therefore, Mr. X would control the new Company which owned both the businesses, although the value of his interest in the two businesses would be considerably less than 50 per cent of the whole.

In the illustration given above, Mr. X is an individual; but he may just as well be a Limited Company. And many cases occur in which shares are held "three deep" and "four deep"—that is to say, where Company "A" holds a controlling interest in the Share Capital of Company "B", Company "B" holding a controlling interest in the Share Capital of Company "C"; and Company "C" may, in its turn, hold a controlling interest in the Share Capital of yet further Companies. The real control of all the Companies in such a case is therefore in the hands of Company "A".

In some instances the position is still further complicated by "cross holdings" of shares, since Company "C" may hold shares in Companies "B" and "A".

Possible objections to Holding Company control.

The policy of Holding Company Control seems first to have developed in the United States; and, while it has many conveniences and advantages, it can be an evil weapon in unworthy or unscrupulous hands. The possible evils need not be dilated upon. Broadly speaking, they arise by reason of the fact that it is possible, and, indeed, often easy, to obscure the true position as to matters such as the assets, the profits and the ownership of businesses, to the possible detriment of the creditors, the shareholders and the public.

For example, what is termed a First Debenture in a Holding Company may not be found, when the position is looked into at all closely, to constitute a first charge on any assets at all. The Operating Companies whose Ordinary Share Capitals the Holding Company owns may

have Debenture Issues of their own as well as Preference Share Capital, and if a general winding-up were to take place, these Debentures and Preference Shares would have to be paid off before any assets were available for collection by the Holding Company, and for distribution by it to its own Debenture Holders.

Again, there is no legal obligation on Holding Companies to publish the Balance Sheets of Companies in whose Share Capitals they own a controlling interest. The Balance Sheet of a Holding Company may consist, on the assets side, of one item only—as, for example, "Cost of the whole of the Share Capital in Company 'X'" —and the Directors of such Holding Company may, so far as the furnishing of any information is concerned, confine themselves to stating how the profit or the loss of the Subsidiary Company has been dealt with, so far as the Holding Company is concerned. The general practice, however, in such an extreme case as that quoted above, is to furnish considerably more information than this; and in a number of cases the Balance Sheets of the Subsidiary Companies are published with that of the Holding Company, or—in comparatively few cases—a combined Balance Sheet relating to all the subsidiary Companies and the Holding Company is compiled and published.

One other objection to what is generally known as Holding Company Finance may be mentioned here, and that is that, legally, a Holding Company can distribute in dividend the whole of the profits which it, itself, receives as dividend from its shareholding in one subsidiary Company without making any provision for a working loss which another subsidiary Company, the whole of whose share capital it also holds, may have sustained concurrently. If, instead of owning the Share Capital in each case, the Holding Company had owned the businesses as such, the only course open to it, both in law and

also as a matter of financial and accounting practice, would be to set the loss of the one against the profit of the other; but because it happens to own the shares instead of the business, it is under no legal obligation in this connection, as the loss in question is represented, so far as the Holding Company is concerned, by depreciation in the value of its shareholding in the Company in question; and a Company is not, legally, bound in such circumstances to provide for the depreciation of an investment before arriving at the profits available for dividend.

Requirements of Companies Act 1929 in regard to Holding Companies.

Under the Companies Act 1929, however, a Holding Company is required to give to its Shareholders certain information as to the manner in which profits and losses of Subsidiary Companies have been dealt with by it in its accounts. The relevant sections of this Act will be found quoted in Appendix G.

Incidentally, it may be mentioned here that there is nothing legally to prevent a Holding Company from distributing in dividend profits earned by the Operating Company before, but distributed in dividend to the Holding Company subsequent to, the incorporation of the latter Company.

Nor legally is there anything to prevent a Holding Company from distributing as dividend dividends paid to it by the Operating Company out of profits earned prior to the time when the Holding Company acquired the shares. For example, a Holding Company may acquire on 1st January certain £1 shares of an Operating Company at a price of 25s. per share. On 1st February the Operating Company may pay a dividend on such shares out of the profits of the year to the previous 31st December. Yet the Holding Company may legally distribute the dividend so received by it among its own shareholders as dividend notwithstanding that the dividend so received must really have been included in the purchase price of

25s. a share. The objections to courses such as those mentioned above, from the economic and accountancy points of view, are, however, obvious and need no comment.

Means of approaching shareholders with view to purchase of control.

The Shares in one or more Operating Companies which a Holding Company may desire to acquire may be in very few hands. For example, practically the whole may be owned by the Directors of the Operating Companies. Or, again, they may be in many hands, as, for example, where they comprise a public issue.

In the first case, *i.e.* where the shares, practically speaking, are held privately, the members of the Board of the Operating Company both conduct the negotiations and carry through the transactions, as they, and they only, are the sellers. In the latter case, however, the "deal", when finally consummated, is between the purchasing Company and a large number of shareholders; the purchasing Company has therefore to make an offer to each individual in respect of his holding. The usual course is for the Holding Company to confer with the Board of the Operating Company and to endeavour to reach an agreement as to what constitutes a fair offer, and then, at or just before the time when the offer is made to the individual shareholders, the latter receive a circular letter from the Directors of their Company recommending that the offer be accepted.

No matter how liberal the offer may be, it is not unusual to find in a large Company a few shareholders who are difficult and "stand out"—in other words, shareholders who reject the offer. Further, there are often some shareholders who cannot be traced. It is therefore usual to provide in the offer that it shall only be effective if accepted by, say, 80 per cent or 90 per cent (in value) of all the shareholders concerned. The shareholders who do not accept the offer simply retain their old holdings, as they cannot be forced to exchange them. They will

have no interest in the Holding Company, but will merely be interested as before in the Operating Company. While these outside shareholdings exist in the Operating Company, it behoves the Directors of the Operating Company to see that their interests are duly protected. Reference to this point has been made earlier in this Chapter.

With a view to facilitating the carrying through of amalgamations of this class, a clause (No. 155) is contained in the Companies Act 1929, the broad effect of which is that if nine-tenths in value of the shareholders have accepted the offer within a certain time, then after a certain further time the remaining shareholders, if they have not made formal objection to the Court in regard to the offer made to them, will be deemed to have accepted it.

Creation of special class of share to carry control.

A method of amalgamation by means of a Holding Company which has the merit of convenience, economy and simplicity, and which has been adopted on several recent occasions, is illustrated in the following example.

Company A, a large Company owning a very successful business, is desirous of acquiring the equity in Company B, which latter Company is much smaller and is carrying on a business in competition with that of Company A, but without the same degree of success.

The capital of Company B consists wholly of Ordinary Shares; the profits earned by Company B are declining rather than expanding; the dividends on the Share Capital of Company B have been maintained for a number of years at the rate of 7 per cent per annum, but the sums placed each year to general reserve have somewhat declined.

An arrangement is made whereby the shareholders of Company B, by the necessary resolutions, pass a scheme whereunder the Ordinary Share Capital of that

Company is converted into Preferred Ordinary Capital carrying a fixed cumulative dividend at the rate of 7 per cent per annum, but no further participation in profits. At the same time there is created some fresh capital (of quite small nominal total amount) in the form of Deferred Ordinary Shares, and the whole of this capital is then issued to Company A as consideration for that Company guaranteeing a fixed cumulative dividend on the Preferred Ordinary Capital of Company B. The voting rights attached to the Deferred Ordinary Share Capital of Company B are such that so long as the fixed cumulative dividend is paid on the Preferred Ordinary shares, the control of Company B rests with the holder of the Deferred Ordinary Capital, namely Company A.

When such a scheme has been put into operation it will be appreciated that Company A can control and manage the business of Company B in much the same way as if it consisted of a department of its own business.

Steps to be taken, under Holding Company Scheme, to reap benefits of co-operation.

It now remains to comment briefly on the steps which can be taken, when a Holding Company Scheme has become effective, to obtain for the various businesses the benefits of co-operation.

In the first place, it must be remembered that no change at all has taken place in the constitution of the Companies which actually own the businesses. Each Company will, as previously, be governed by the terms of its Memorandum and Articles of Association, and it must continue to have its own books, its own Registered Offices, its own Board of Directors, its own Manager, Secretary, Accountant, etc. The officials of each Company must prepare that Company's annual Balance Sheet, which will be duly audited and submitted by the Directors at the annual General Meeting for the approval of the Shareholders.

But while the Boards of each Operating Company

can exercise the full powers of control over the management of that Company's business which are ordinarily exercisable by Directors, they are, in common with the Boards of all other Companies, themselves subject to the control of the shareholders in that the latter have, at General Meetings, the right to re-elect them or to remove them. And where, instead of the shares being owned by a large number of individuals, they are all, or nearly all, owned by a Holding Company, the Board of such latter Company exercises the functions which the many individuals, as a body, would otherwise have exercised. The Board of the Holding Company, therefore, appoints and removes the Directors of the Operating Companies, receives the Report and audited Accounts submitted annually at the General Meetings of the Operating Companies, and appoints the Auditors of such Companies.

(The Board of the Holding Company, in its turn, is of course subject to the control of the shareholders of the Holding Company, exercised on the occasions of the General Meetings of such shareholders.)

It will therefore be appreciated that the Board of a Holding Company has no legal right to take part in the direction or management of the business of an Operating Company whose shares it owns; this function resides with the Board of the Operating Company. At the same time, the Board of the Operating Company is aware that if it takes important steps, or pursues a certain line of policy, contrary to the wishes of the Board of the Holding Company, the latter Board will exercise its power on behalf of the Holding Company and will dismiss the Directors of the Operating Company, filling their places with men whose actions will, it believes, reflect its own views. This situation is recognised in practice, and, for convenience of working, it is usual for most of the important matters which require discussion and decision in connection with the business of the Operating Companies

to be debated at a Joint Board on which there sit Directors of the Operating Companies, and also Directors of the Holding Company. (It is frequently the case that a Director of a subsidiary Company—referred to here as an Operating Company—is also a Director of the Holding Company.) This Joint Board is an entirely unofficial body, but it is representative. Minutes are kept of the decisions which are come to, and these decisions, so far as they affect the business or affairs of an Operating Company, are communicated to the Board of that Company, which, at its next meeting, passes a minute giving practical effect to the decision. Thus, while the decisions are officially those of the Boards of the Operating Companies, they are, in effect, those of the Board of the Holding Company.

It is, however, hardly necessary to mention that co-operation as the result of a Holding Company Scheme is not, by any means, confined to the dictation of the policy and the general conduct of the businesses concerned by a Joint Board of Directors. The various responsible officials of each Company, such as General Manager, Works Manager, Heads of Departments, Engineers, Chemists, Accountants, etc., would all collaborate in order that each might benefit from the experience of the others, to the advantage of the business as a whole. In other words, there would be a pooling of brain power.

With the object of aiding the process of collaboration, it is not unusual for certain Directors to be common to the Boards of two or more of the Operating Companies.

In Chapter II. detailed reference has been made to the various advantages which are, or may be, reaped as a result of mergers, and a little consideration will enable any one who studies this aspect of the subject at all closely to realise the extent to which these may be looked for under a Holding Company Scheme. Clearly, it is not

possible, in a merger by means of a Holding Company, to carry the unification of the working of the businesses so far as in a scheme of Complete Amalgamation; in the former case each operating Company has to maintain a separate organisation, whereas in the latter case everything becomes merged, as the businesses themselves are under the ownership of the same entity. To what extent the Holding Company Scheme is, in this particular respect, likely to be inferior to a Scheme of Complete Amalgamation depends entirely upon the circumstances of the case. Many factors may enter into the consideration of this point—*e.g.* the locations of the businesses; the necessity, or otherwise, of preserving the appearance of competition as between the businesses; the necessity for safeguarding, in the case of the Holding Company Scheme, the interests of outside shareholders in the Operating Companies. Enough has, however, been said here and in earlier parts of this book to indicate the main features of the problem.

Holding Company Scheme no bar to a complete amalgamation later.

One point should, however, be mentioned in conclusion, and that is that a Holding Company Scheme does nothing to prevent or hinder a scheme of complete amalgamation being arranged at some later time, if such a course should then be considered expedient.

Summary of advantages and disadvantages of various forms of merger.

As mentioned in an earlier chapter, a summary of the advantages and disadvantages of various forms of merger will be found elsewhere in this book, namely, in Chapter XIV., in the form of a Tabular Statement.

CHAPTER VII

CONSIDERATIONS ARISING IN CONNECTION WITH A MERGER BY MEANS OF A POOLING AGREEMENT

Introductory remarks.

THERE have now been considered the two forms of merger which are most commonly found, namely, the " Complete Amalgamation " and the " Holding Company Scheme ". It now remains to comment upon a third form of merger, or unification of interests, namely, that by means of a Pooling Agreement, whereunder the future profits of two or more businesses, for a term of years, are first " pooled ", that is to say, are brought into a common fund, and are then divided out in a ratio or on a basis defined in the agreement. Mergers by means of pooling agreements are not so common as are those of other classes ; but they are by no means rare.

A Pooling Agreement, it is to be noted, does not in any way lead to a commingling of the assets of the businesses in question. Nor does it affect the organisation of either business or the constitution of the Company owning such business. The effect which it exercises is achieved by its influence on the course of action of those responsible for the direction of each business. Those in control of each business are still interested in carrying on that business as successfully as possible, but with the following reservation—that success must not be purchased at the expense of one of any of the other businesses which are parties to the pooling agreement. In fact, the owners of each business, while doing all in their power to improve that business for the benefit of all parties, are equally interested that the other businesses should prosper. Each business which is a party to the pooling agreement is

engaged in earning profits for the whole of the parties to the pool—in just the same way as a partner in a professional firm (as, for example, a firm of Solicitors) is interested in earning profits for the firm of which he, as a member, is entitled, under the partnership agreement, to a certain share.

This community of interests under a pooling agreement secures, or should secure, many of the benefits of co-operation set out in Chapter II., although it cannot secure a number of them to the same full extent as would be the case under a scheme of Complete Amalgamation, nor probably to the same degree as would be possible under a Holding Company Scheme.

Advantages of Pooling Agreement.

Wherein, then, lie the special advantages of a Pooling Agreement?

Secrecy.

In the first place, there is the possible advantage of secrecy. The Companies owning the businesses in question may be openly engaged in competition and it may be considered inexpedient that the suppliers, customers and the public generally should know that their interests are really identical. The terms of the agreement would be negotiated and settled by the Boards of each Company; and although, in the ordinary way, the Directors would consider it necessary to obtain the consent of the shareholders to any action of far-reaching importance, yet under the special circumstances they might well think—and be right in thinking—that, in the best interests of the shareholders themselves, the strictest secrecy was demanded.

Little initial disturbance or expense.

Then, again, of all the forms providing for a merger of interests, that of the pooling agreement is probably attended by the least initial disturbance and expense. No new Company has to be formed; no existing Company requires to be liquidated; no valuation of assets need be made; no conveyance of assets is necessary; no duties require to be paid either on Share Capital or on the

conveyance of assets; no meetings of shareholders are requisite, nor have the shareholders necessarily to be communicated with.

At termination of agreement the *status quo* can be resumed.

Another advantage of a pooling agreement is that when the time fixed by the agreement is ended the parties can, if they prefer it, revert to the old conditions. On the other hand, if they so desire, they can extend the pooling agreement for a further term of years. Under a Scheme of Complete Amalgamation, the parties are indissolubly joined together "for better or for worse"; and even under a Holding Company Scheme it would be very difficult to "unscramble the eggs" if those interested wished, at some subsequent time, to part company.

When agreement is terminated it can be renewed.

Pooling Agreement as a step towards closer association.

A further possible advantage of a Pooling Agreement is that it enables the interested parties to co-operate to a considerable extent and consequently to become more fully acquainted with each other; and this acquaintanceship may be a very useful stepping-stone to a Complete Amalgamation at a later stage. If, therefore, a "Complete Amalgamation" is equivalent to a "marriage" of the contracting parties, a pooling agreement may be likened to what is known among the working classes as a "walking out"—*i.e.* a process which enables the parties to know and understand each other better before they enter into a closer contractual relationship which cannot be dissolved.

Basis for dividing the pooled profits.

If the parties concerned have come to the conclusion that a Pooling Agreement is best suited to the circumstances of their case, the first question for them to consider is the basis on which the division of the pooled profits is to be arrived at. The basis usually adopted is that of the profits of each business for some past series of years. The period need not necessarily be the same in the case of each business; it should, however, be chosen with the object that it fairly reflects the anticipated future earning capacity of the business in question relative to those of the other businesses.

It is perhaps hardly necessary to say that the profits to be pooled during the term of the agreement are to be arrived at in the same manner as the profits of the period or periods taken as the standard.

Profits for pooling purposes, certified by independent accountants.

The agreement usually provides that the profits, both for the standard period and also for each year covered by the agreement, are to be certified by one or more professional accountants.

If there are only two parties to the Pool, it may be found most convenient for the auditors to each party to make jointly the inspection of accounts and give the necessary certificate ; and in the event of a difference of opinion between them the matter would be referred to arbitration. Where, however, there are three or more parties to a Pool this method may prove unduly cumbersome and expensive ; and in such a case it will probably be found most convenient for the figures relating to each party to be prepared by that party's own auditors, but for an entirely independent firm of Accountants, not representing any of the parties, to check the figures and give the certificates.

Manner in which profits are to be arrived at.

As Accountants are well aware—and as most business men will appreciate—there are few words in business which are capable of so many interpretations as the word "profits". While, therefore, the exact treatment of certain of the figures in arriving at "profits" under a Pooling Agreement must be left to the Accountants who have to certify such profits, it is very necessary that, so far as possible, the Pooling Agreement should define how the profits are to be arrived at. In this connection it must be remembered that the circumstances of no two Pooling Agreements are identical ; and that important considerations entering into the ascertainment of profits may be present in one case but absent in another. It is only possible, therefore, to refer here to the most usual points requiring special consideration.

One point which may be of considerable importance, and which will, in all probability, require to be dealt with in some form in the Pooling Agreement, is that of *Depreciation—e.g.* Depreciation of Buildings, Plant, Machinery, etc. Obviously all the parties to a Pooling Agreement must deal with depreciation in arriving at their profits for purposes of such an agreement in a fair and proper way. If the charge made in respect of depreciation in the case of any business is unduly low, the profits of that business are over-stated; and similarly if the charge made is excessive, the profits are under-stated.

Charge for depreciation.

One obvious means of dealing with the situation is to provide that as regards the standard period the actual charge which each party made for depreciation in its own accounts should stand, and that the same basis, in regard to each party, should be followed in respect of the period covered by the Agreement. Such an arrangement has the advantage of simplicity; and, from the point of view of equity, it has this to recommend it—namely, that if the charge made by one party for depreciation in the standard period was unduly high, and therefore that party's standard profits were unduly low, the party would obtain proper compensation for this during the term of the agreement, as the ascertained profits which it was required in each year to contribute to the Pool would be smaller than would otherwise be the case, as, in arriving at such profits, the same high charge for depreciation would be made.

For example, Business "A" may have earned profits in the period chosen as a standard (before charging Depreciation) averaging £100,000 a year, and Business "B" may show similar profits in the standard period. In the Accounts of Business "A" too little depreciation has, however, been charged, the debits appearing in the annual Profit and Loss Accounts averaging £5000. Business "B", however, has dealt with its depreciation

Another basis which may be adopted is to provide that depreciation shall be calculated—both in the standard period and in the period of the Pool Agreement—at certain fixed rates applied to the book values of the assets of different classes to which depreciation relates. Here, again, however, difficulty may be experienced, if the " book values " in the case of each party to the Agreement have not been arrived at on exactly the same basis. It may, for example, be the case that, in respect of one party, the " book value " represents a " written down " figure, whereas in the case of another party it may represent the original cost of the assets. If such a state of affairs were found to exist, it would clearly be unfair to apply flat rates of depreciation to figures representing " written down values " in the one case, and to figures representing " original cost " in the other case.

In cases where the businesses of all the parties to the Pooling Agreement are situated in the United Kingdom (or where they are situated abroad but owned by an English Company, or controlled from England), a convenient measure of what is a fair and proper charge for depreciation may be found in the allowances given under this head by the Inland Revenue Authorities for Income Tax purposes. Where, however, the business of one or more parties to a Pooling Agreement is not subject to English Income Tax, no such standard for the purposes of a Pooling Agreement can be adopted.

Charge for repairs and renewals.

Incidental to the question of depreciation is that of repairs and renewals. A charge for depreciation, as such, is presumed to be superimposed on the charge for ordinary maintenance of the assets in question—*i.e.* the expenditure necessary year by year, in the form of general repairs and of renewals of parts, to keep the assets in question in an efficient working condition. It is, not infrequently, a matter of some difficulty to define exactly what expenditure is to be regarded as " Maintenance "

expenditure, and chargeable to Profit and Loss Account as and when incurred, and what expenditure is to be regarded as representing a renewal of an asset which has been the subject of a provision for depreciation, and which expenditure would therefore either be charged to Capital Account (if the original asset had been written off) or met out of the accumulated reserve for depreciation (if the original asset still stood in the Capital Account).

In the case of some classes of assets, nearly every part is renewable, and is, as a matter of fact, renewed, when it wears out, so that in the course of time very little is left of the original material out of which the asset was constructed in the first place. Some of the parts may have short lives, while others may have comparatively long lives. As a general rule, however, a stage is at last reached when (in spite of the bulk of its parts having been renewed when required, and therefore being in themselves in an efficient condition) the asset as a whole is, by reason of obsolescence or otherwise, an uneconomic unit, and must be scrapped. As an example of such assets may be mentioned railway wagons. In cases such as these it is necessary, in framing the basis of charge for depreciation, to define carefully the expenditure which is, and the expenditure which is not, intended to be covered by such charge.

Enough has been said above in regard to this matter of depreciation to make it clear that the decision as to the basis to be adopted must depend upon the circumstances obtaining in each case.

Charges in respect of Directors' remuneration.

× Another question in connection with the ascertainment of profits which has not infrequently to be specially referred to, pooling agreements is that of Directors' and Managing Directors' remunerations. In the absence of any restrictions or stipulations imposed by the agreement, it would be possible for one of the Companies which is a party to the Pool to pay away unduly lavish sums under

those heads, whereas the charge would, in effect, be borne by all the parties concerned in the pooling arrangement. The danger in this connection would be specially present where the Directors of the Company in question held, between them, a controlling interest in the Share Capital of the Company.

Charges in respect of bad debts.

It is sometimes thought advisable, in pooling agreements, to place some limitation upon the amount of the losses from Bad Debts which each party to the agreement can charge in arriving at its profits for Pool purposes. Such a limitation may constitute a wholesome deterrent against any of the parties to the agreement taking undue risks in regard to the class of customer with whom they do business, or the length of credit which they think it proper to give. If such a limitation is imposed, a convenient basis is that of turnover, *i.e.* a stipulation that the charge in respect of bad debts shall not exceed a certain percentage of the turnover.

Allowance for additional capital employed.

It will be appreciated that proper allowance must be made to any party to a pooling agreement in respect of any capital employed in his business over and above that employed during the period which was taken as a basis for determining the proportions in which profits are to be pooled. For example, if " A " and " B " are parties to a Pooling Agreement, and their past profits (on an average of a certain number of years) have amounted to the following sums: " A " £5000, " B " £3000, the Pooling Agreement would provide that the combined profits during the term of such agreement should be shared in the ratio of five to three.

But if " B's " business began to expand rapidly, and in consequence " B " had to add considerably to his Works, Plant, Machinery, etc., whereas " A's " business continued stationary, it would be unfair that the whole of the profits of the two businesses, including the profits

arising from " B's " new Works and Plant, should still be shared in the ratio of five-eighths to " A " and three-eighths to " B ".

It is therefore usual to provide, in Pooling Agreements, that in arriving at the profits of each party for purposes of the Pool, interest should be charged on any capital employed in excess of the capital which was employed during the period which has been taken as the standard. In other words, the party employing the extra capital can first take out of his profits and retain for himself a sum representing interest on such excess capital, and only hand over to the Pool the profits then remaining. What this rate of interest should be must depend upon the nature of the businesses in question and the general circumstances of the case. It should be sufficiently high to make it worth the while of any party to extend his business if the prospects clearly seem to warrant it ; and, on the other hand, it should be sufficiently low to deter any party from making extensions to premises, plant, etc., where there seemed to be a considerable risk that the extensions would not, from an economic point of view, be justified.

Restriction as to capital expenditure.

It is possible, by the terms of the Pooling Agreement itself, to impose some restriction upon excessive development, as, for instance, by a provision that if any party to the agreement starts a new Department or Branch, the other parties can, by a vote of the majority (in value), decide whether the profits or losses of such new department or branch shall or shall not be brought into the Pool.

Disposal of part of a business.

Correspondingly, a clause can be inserted in the Pooling Agreement whereunder no party to the Agreement can dispose of any part of his business without the consent of the majority of the other parties.

A little consideration of the subject will suggest other clauses which may properly be inserted in Pooling Agreements for the proper protection of all parties. For ex-

Contracts with officials as to terms and conditions of service.

ample, it is important that each party should, broadly speaking, be equally protected as regards the continuance in office of the most important officials such as Directors and Managing Directors; and also in regard to undertakings by such persons not to enter into service with competing businesses. Again, the agreement might restrict any of the parties from entering into mergers or pooling agreements with outside parties.

Disclosure of outside interests.

Further, it occasionally happens that concerns which are parties to a Pooling Agreement may have very close business relations with other concerns, the ownership of both concerns being to some degree the same. In such circumstances it is very important that the parties in question should be forced, by the Pooling Agreement, to declare the exact nature of these interests to the other parties to the Pool, and also to afford to those parties (either directly or through their representatives, such as Accountants) the opportunity of reviewing the business transactions and relations in order to see that they are carried through on the same basis as would be the case where the two contracting parties had no interests in common.

Maintenance of secrecy.

The Pooling Agreement might also contain a clause binding each party to secrecy in regard to the agreement; and a further clause would recite the endeavours of all the parties to work in harmony with and in loyalty to each other.

Termination of agreement in certain eventualities.

The question should be considered as to whether the Pooling Agreement ought not to contain a clause to the effect that if any company which is a party to the Pool goes into liquidation, or loses a certain proportion of its Share Capital, the other parties should have the right to terminate the agreement.

Position where operating losses are sustained.

It must be remembered that an arrangement to share profits contemplates also the sharing of losses, and consideration should be given to the question of whether losses should be shared to the same full extent as profits, or whether, in this connection, some restrictions should

not be imposed, for the benefit of the parties who do not make losses. It might, for example, be provided that, in the event of one party making a loss, the amount of the loss, for Pool purposes, should be restricted either by a definite maximum figure being quoted in the agreement, or by the amount being limited to a certain percentage of the loss actually sustained by the party.

For example, " A " and " B " may pool profits in the ratio of three-fifths and two-fifths—the respective profits for the basis period averaging per annum for " A " £3000 and for " B " £2000.

It might be stipulated, either

(i.) that for pool purposes no loss can be considered in excess of £1500 for " A " and £1000 for " B "; or

(ii.) that if a loss is made, not more than 50 per cent thereof can be brought into account for Pool purposes.

If in one particular year, therefore, " A " made a profit of £3000 and " B " a loss of £1500, then the treatment for Pool purposes would be as follows:

Under (i.) " A " would pay into the Pool £3000 and " B " would draw out £1000. This would leave £2000 in the Pool, of which " A " would take out three-fifths = £1200 and " B " would take out two-fifths = £800.

In effect, therefore:

" A " would be left with profits of . .		£1200
While " B " would have first made a loss of .	£1500	
But he would have drawn out of the Pool in the first place	1000	
Leaving his net loss	£500	
And he would then share to the extent of two-fifths in the £2000 in the Pool, *i.e.* .	800	
Leaving him with a profit of		300
Total Net Profit		£1500

Which was originally composed of—		
Profit by " A "	£3000	
Less Loss by " B "	1500	
		£1500

The treatment for Pool purposes under (ii.) would be as follows :

" A " would contribute to the Pool . . .	£3000	
" B " would draw on the Pool for 50 per cent of his loss of £1500, *i.e.* for . . .	750	
There would be left in the Pool . . .	£2250	
Of which " A " would be entitled to three-fifths, equals		£1350
And " B " to two-fifths, namely . . .		900
		£2250

" A " would therefore receive		£1350
While " B " would first lose . . .	£1500	
Of which he would get back from the Pool at the outset	750	
Making his net loss	£750	
And he would then receive from the Pool on its division, two-fifths of £2250, namely .	900	
Making his net profit		150
Total Net Profit . . .		£1500

which was originally composed as follows :

Profit earned by " A "	£3000	
Less Loss made by " B "	1500	
		£1500

Dates for payment of moneys into Pool.

The Pooling Agreement must of course define the dates on which the payments into the Pool are to be made by the various parties ; and it would be stipulated that in respect of any delay in the payment in of moneys,

interest in respect of the period in question should be charged to the party in arrear with his payments. The rate of interest should be a high one in order to constitute a penalty; except, however, in the event of the delay being due to the non-agreement of figures for which the party in question was not responsible, in which event a moderate rate of interest would be charged.

Period of Pooling Agreement.

The period which the Pooling Agreement is to cover is a matter which requires early consideration. It is true that if a short period is decided upon, the agreement can, with little or no trouble or expense, be extended for a further period. On the other hand, it is submitted that if parties are to work in as close co-operation as a Pooling Agreement contemplates, they should be prepared to enter into the arrangement for a reasonably lengthy term of years—say, at the least, for ten years. To make an agreement for a shorter period than this implies a lack of faith on the part of the contracting parties; and further, it is calculated to lead to each party paying too little attention, during the period of the agreement, to the "common good" and thinking too much of the time when the agreement will have come to an end, and when unrestricted competition will presumably once more ensue. This line of thought—a not unnatural one under the circumstances—does not make for real harmony and co-operation but leads to each party playing for his own hand, thus defeating, in part, the object for which the Pool was formed.

Arrangements to facilitate co-operation between parties to Pooling Agreement.

For purposes of co-operation between the parties to a Pooling arrangement, the agreement will probably stipulate for the formation of a Joint Committee, chosen from among those responsible for the general administration of the affairs of each business. The Joint Committee would of course be subject to the control of those owning

the businesses in question—*i.e.* in the case of Limited Companies, the Boards of Directors.

To a considerable extent the functions of this joint committee would be similar to those of the joint board or committee referred to in connection with the Holding Company scheme (Chapter VI.). The decisions of the Committee would not of themselves be binding or operative; but they would be passed on to the appropriate boards of directors, who, after adopting them, would give the necessary instructions putting them into effect.

Disadvantages of Pooling Agreements.

The disadvantages of a merging of interests by means of a Pooling Agreement may be summarised as follows:

Full benefits of merger cannot be reaped.

(*a*) Inasmuch as a Pooling Agreement does not provide for a commingling of the assets of the various parties, nor for centralisation of administration, and inasmuch as the arrangement is for a term of years only and not permanent, the full benefits of a merger cannot be obtained under it. And particularly is this the case where, as most frequently occurs in regard to Pooling Agreements, secrecy is required.

Annual inconvenience and expense.

(*b*) A certain amount of inconvenience and expense is incurred annually in connection with the investigations into the profits of each of the parties to the agreement, in order to ascertain the sum which each party has to contribute to, or draw from, the Pool. Not infrequently contentious points arise in connection with the agreement of the figures, and these do not make for harmony between the parties, and are conducive to an atmosphere contrary to that of co-operation.

Limitation of Agreement as to time restricts full co-operation between the parties.

(*c*) The fact that the Pooling Agreement is limited as to period, leads, or may lead, to each party paying too much regard to what will happen when the agreement has terminated, and too little regard to the position under the agreement itself. In other words, a party may be in-

duced to conduct his business with a view to making it as strong as possible when the period of the agreement is ended and it is once more placed in competition with the businesses owned by the other parties to the Pool. As a consequence, he may be apt to think of his own interest only, and not to give sufficient consideration to those of the other parties to whom he is, for the time being, allied. Such an attitude of mind very much curtails the benefits which should be looked for under the agreement.

Difficulty of admitting, subsequently, additional parties to the Agreement.

(*d*) A further possible objection to a Pooling Agreement lies in the difficulties which may be experienced at some subsequent date by admitting additional parties to the arrangement if such should be thought desirable. In the case of a Complete Amalgamation, and also in the case of a merger by means of a Holding Company Scheme, it is usually relatively easy to arrive at the fair value of any further Share Capital which the Company owning or controlling the Combine would issue to the owners of another business in consideration of that business being taken over by the Combine. The new Share Capital would presumably rank *pari passu* with existing Share Capital, and, in regard to the latter, the prices at which any recent transfers from one party to another had taken place would be known; and, further, the value could be measured to some extent by the profits shown by the recent Accounts as available for dividend, and by the dividends actually distributed. Further, the Combine in making an offer for the business would define the manner in which the business was to be valued.

A party who joined at some subsequent date a number of other parties who were already pooling their profits would, or might, however, require to look into the whole basis on which the standard profits of the parties, for pooling purposes, had been arrived at; also, he would want to know what the profits were since the pool commenced and how these had been computed. And, further,

he would then wish to compare these figures with those relating to his own business. As will be appreciated, such a procedure might lead to difficult and contentious questions arising between the old parties and the new before an arrangement could be come to to the satisfaction of all.

Example in Appendix B of profits adjusted for purposes of a Pooling Agreement.

In Appendix B is set out a *pro forma* example, showing, under an imaginary Pooling Agreement between two parties, how the profits, both of the period taken as a standard and also of the first year under the agreement, are adjusted for the purposes of the Pool.

Pooling Agreements may be confined to certain profits only, or to a proportion only of certain profits.

It is necessary to mention that a Pooling Agreement need not necessarily concern the whole of the profits of the businesses of the contracting parties. It may, for example, be confined to the profits of certain departments of the businesses; or, again, a certain proportion only of the total profits of each business may be pooled and redistributed, the remaining portion being retained by each party.

Pooling Agreements may be based on Sales.

Again, Pooling Agreements may relate to, and be based on, *Sales* instead of Net Profits. For example, the parties may ascertain their respective sales (either in quantity or in value) for a certain past period which would be taken as the standard, and each party may arrange, under a Pooling Agreement, to pay into or receive from a Pool according to whether its Sales for the period of the agreement formed a larger or a smaller proportion of the sales of all the parties than was the case during the standard period.

Let it be assumed, for illustration, that the sales, in quantity, of three parties for the standard period are as follows:

"A"	600 tons
"B"	900 ,,
"C"	1500 ,,
Total .	3000 tons,

and let it be assumed that payments into and out of the Pool are to be at the rate of £2 a ton.

The percentages which the sales of each party bear to the whole, during the standard period, are as follows :

" A "	20 per cent
" B "	30 ,,
" C "	50 ,,
	100 per cent.

Let it be assumed that in the first financial period under the pooling agreement the tonnages sold are as follows :

Sold by " A "	675 tons
,, " B "	1125 ,,
,, " C "	2700 ,,
	4500 tons.

The tonnages actually sold by each party represent the following percentages of the total sales :

" A "	15 per cent
" B "	25 ,,
" C "	60 ,,
	100 per cent.

	£
" A " therefore, while entitled to sell 20%, has only sold 15%, so that he is entitled to *take out of the Pool* £2 a ton on 5% of 4500 tons = £2 × 225	= 450
" B ", while entitled to sell 30%, has only sold 25%, so that he is entitled to *take out of the Pool* £2 a ton on 5% of 4500 tons = £2 × 225	= 450
	900
" C ", while entitled to sell 50%, has actually sold 60%, so that he is required to *pay into the Pool* £2 per ton on 10% of 4500 tons = £2 × 450	= 900

Agreements for maintenance of prices or for pooling of selling organisations.

Various other forms of co-operation between businesses exist which do not involve what is commonly regarded as an Amalgamation. They do, however, mean a partial unification of interests.

For example, it is not uncommon for agreements to be entered into in certain trades regarding the maintenance of selling prices.

Such an agreement may merely concern the selling prices themselves, or it may extend somewhat further than this and fix for each of the parties concerned a "standard" total of annual sales. Each party selling more than the percentage which his standard bears to the total standards of all the parties would be required to pay a sum (based on the excess) into a pool, and the sums so paid into the pool would be distributed among those parties whose actual sales represented less than their respective standard percentages.

It is also not uncommon for various undertakings, or businesses, to co-operate in regard to selling by forming a special Selling Company. The Capital of this Company would be held in agreed proportions by those interested in forming it, and its functions would be to obtain orders for the output of the producing Companies, and to undertake the general supervision of the execution of such orders. The orders obtained would be allocated between the various producing businesses interested in some agreed ratio which might be in ratio to their respective outputs over a past period, or in ratio to their capacity, or in some ratio which takes both the above circumstances into account. It will be appreciated that the Selling Company might obtain some orders for a certain standard article at a good price, and certain other orders for the same article at less remunerative prices. The fact that it allocated the first-mentioned orders to one producing Company and the second-mentioned orders to another producing Company would not mean that the first Com-

pany should obtain the whole of the benefit due to the higher prices. The agreement in connection with the formation of the Selling Company would provide that in such cases adjustments should afterwards be made as between the different producing Companies.

Other adjustments might conceivably require to be made in cases where, for economic reasons, one producing Company was allocated orders in excess of its quota or proportion, while another producing Company was allocated a smaller ratio of the total orders than was due to it according to the standard which had been set up.

It may be submitted that arrangements such as those outlined above—that is, as regards maintenance of selling prices or co-operation in selling activities—hardly fall within the scope of this book. It is, however, necessary to refer to their existence, if for no other reason because of the fact that they frequently are the prelude to a subsequent amalgamation. They are somewhat akin in character to arrangements under a Pooling Agreement, and it has therefore been thought that the most appropriate place in which to refer to them would be at the end of the chapter which deals with Pooling Agreements.

Summary of advantages and disadvantages of various forms of merger.

As mentioned in previous chapters, a summary of the advantages and disadvantages of various forms of merger will be found in Chapter XIV., in the form of a Tabular Statement. It has been thought preferable that this Tabular Statement should appear after, rather than before, the chapters which deal with the valuations of assets and the ascertainment of profits, as it is considered that after reading these last referred to chapters the reader will have obtained a better idea of the nature of the work to be carried through and the steps to be taken in connection with each class of merger.

CHAPTER VIII

FIXED ASSETS—POINTS ARISING ON A VALUATION OF THESE FOR PURPOSES OF AN AMALGAMATION

Introductory remarks.

As already mentioned in Chapter V., a business may be valued for amalgamation purposes by aggregating the values of its Assets—fixed, floating, and intangible (such as Goodwill)—and deducting from such total the value of the Liabilities; or, alternatively, by measuring its earning capacity only. The choice between the two methods depends, as already explained, on the circumstances of the case.

It must therefore be understood that any comments made in this chapter do not necessarily concern every business which owns fixed assets, but only such businesses where the circumstances of the case dictate the valuation of fixed assets as being one of the stages in the valuation of the business as a whole.

The fixed assets most usually met with in the cases of businesses which are the subjects of amalgamations are land, buildings, plant, machinery and other equipment, and investments; and it may therefore be appropriate to make a few remarks in regard to the appraisal of each of these classes of asset.

LAND.

LAND

Parties may agree upon values between themselves.

It may be possible for the parties to come to an agreement between themselves as to what are the respective values of the land which each owns; and such a course is not improbable where the land in each case has been recently acquired, as the price then paid for it can presumably be taken as somewhat of a guide to its value.

LAND.

In the majority of cases, however, where a value requires to be placed upon land for amalgamation purposes, it is found advisable to utilise the services of an independent expert—*i.e.* a Surveyor. In this connection it is important to bear in mind that the values placed upon a piece of land by different independent experts, after full and fair consideration of the circumstances, may vary considerably; and it is therefore necessary that the same valuer or firm of valuers should be employed to value the land owned by each of the parties to the merger. By employing one expert for the whole of this work, there is at least the assurance that whether the values put upon the land owned by the various parties subsequently prove to have been on a somewhat high scale or on a somewhat low scale, they are at least consistent; and, as has already been indicated, the chief consideration is that the values attributed to each business should be fair *in relation to each other*.

Independent valuation may be necessary.

Advisable for same valuer to be employed in case of all businesses.

In cases where special local knowledge may be necessary in order to value correctly land or premises situated in a certain district, it may be advisable to instruct the valuer who is entrusted with the valuations as a whole, to employ the services of local valuers to whatever extent may be appropriate.

Valuer may have assistance of local valuers.

It is perhaps unnecessary to mention that the purpose for which the valuations are required should be carefully explained to the valuer in advance; and if, when the valuer comes to consider all the circumstances of the case, he is under any doubt as to the lines on which he should proceed, he should bring the points in question before the interested parties and take their instructions.

Full information to be given to valuer.

The parties should supply to the valuer all the data in their possession in regard to the land, *i.e.* plans, area, rights of way, charges (such as tithes), restrictions limiting the use of the land in any respect, so that he may have the fullest possible information.

LAND.

In the case of land occupied by the Works and other buildings of the business, the circumstances in regard to the buildings may have a bearing upon the value placed upon the land ; but this point would present no difficulty, as it is the invariable custom to employ in such a case the same valuer to value the buildings as the land.

The value placed by the valuer upon land adjacent to Works or other freehold buildings owned by the business will probably depend to a considerable extent on whether extensions to Works, etc., are at all likely to be required at some not too far distant future date, and whether the land in question is suitable for extensions.

Land having special value for outside purposes.

It may be the case that comprised in the assets owned by a party to an amalgamation is land which may be relatively of little value from the point of view of the possible future development of the business, but which yet may have a very considerable value for other purposes, such as a site in a city which may be eminently suitable for the erection of shops or offices.

In such a case the valuer would clearly be right in attributing the proper market value to this land, as it could presumably be disposed of, either by the existing owner or by the new combine, for cash, which would then be available as part of the liquid resources of the business.

In a case where land is unlikely to be required by the business and where it has, for purposes such as those mentioned above, a special value, it is not unusual for provision to be made in the agreement providing for amalgamation, that the party owning it can, if he so desires, except it from the assets to be taken over by the new organisation. In circumstances where a business as such is bought for purposes of amalgamation with another, and the land belongs to the vendors, it is a simple matter so to except it.

Where, however, the land is held by the purchasing body and the latter is a limited company, the situation is

more complicated. One obvious alternative is for the land to be sold prior to the amalgamation, and for the owning company to distribute an amount equivalent to the proceeds among its shareholders, either in the form of dividend or as a return of capital—as circumstances may warrant. Similarly, where the amalgamation takes the form of a Holding Company scheme and the land belongs to the Company whose shares are to be purchased, the land can be sold prior to the date as from which the shares are to pass, and the proceeds distributed among the shareholders entitled thereto. The above procedure assumes, however, that the land must forthwith be sold, whereas it may be the desire of those who have the beneficial interest therein that it should be retained. In such an event it may be possible, in cases where the shareholders are few in number, and where the Articles of Association permit it, to make a distribution in kind (*i.e.* to hand over the land itself to the shareholders), and at the same time, in order to avoid parcelling out the land among the various individuals, to form a trust whereunder it would be held by trustees who in dealing with the land at any time would be subject to the directions of a majority in value of the shareholders who jointly owned it. LAND.

Valuer's charges.

Stipulation as to completion of valuation.

In making arrangements with the valuer, the question of the amount or basis of the fee to be paid for the valuation should be settled in advance; and some stipulation or understanding should be come to in regard to the time within which the valuation is to be completed. Further comments on these matters will be found in later paragraphs in this chapter.

BUILDINGS (*i.e.* Works, Factories, Warehouses, Shops, Offices, etc.)

BUILDINGS.

Parties may agree upon values between themselves.

It may be possible for the parties to an amalgamation to agree with each other as to the values at which their

BUILDINGS.

respective buildings should be taken for purposes of the merger, without going to the trouble and expense of employing the services of an independent professional valuer. One possible basis in such a case is that of original cost, less depreciation at a certain percentage rate or rates. In the great majority of cases, however, where the values of buildings have to be arrived at for amalgamation purposes, such a course is, for various reasons, impracticable.

Independent valuation will probably be necessary.

Circumstances which expert valuer will take into account.

For example, certain buildings may have been erected in pre-war times when costs were relatively low, while others may have been constructed during the war or in post-war times when costs of labour and materials were relatively on a much higher scale. Again, it may well be the case that the buildings of certain of the parties may, by general "lay out", be much more effective for the purposes of the particular business than may be those of other parties; and circumstances like these would properly be taken into account by the professional valuer in arriving at his valuation.

Again, it may well be the case that some of the buildings were originally constructed on special lines for particular work quite different from their current use. New buildings of simpler construction, smaller floor space and perhaps of reduced loftiness might be far better suited to the needs of the present business and cost less to erect than the value of the existing buildings on the basis of their worth to a going concern able to utilise them fully as originally designed. It may even be that buildings, inherently sound, are so ill-adapted for the needs of the special business concerned as to be practically valueless. It is therefore of the utmost importance that critical consideration should be given to the suitability of each building to the particular requirements of the business involved.

Yet again, one of the parties may, by executing all necessary repairs and renewals promptly, have kept his

BUILDINGS.

buildings up to a much more efficient state of repair than another party; and this circumstance would also be taken into consideration by the valuer in making his appraisal.

Valuer's certificate in connection with Prospectus.

Another advantage in employing an independent expert valuer and obtaining from him a certificate as to the value of the assets in question is that the publication of this certificate may be of considerable value in any prospectus which may at some future date require to be issued inviting the public to subscribe for Share or Debenture Capital.

Same valuer to be employed in all cases.

Where a professional valuation is required, the same valuer or firm of valuers should be employed to value the buildings of all the parties, for reasons already explained above in relation to the valuation of land.

Valuer to be given full information.

The valuer should be informed of the purpose for which his valuation is to be used, and he should be furnished by the parties with full information concerning the assets which are to be the subject of his appraisal. Instructions should also be given him as to the basis of the valuation—such basis being that of a fair price as between a willing buyer and a willing seller, the buildings being regarded as forming part of a going concern. The term "going concern" in this connection not only means that the business is in operation, but also that it is being operated at no less than a moderate or reasonable profit. The reason for this basis of valuation is that if it is found, when all the assets of the business, both fixed and floating, have been valued, that the profits earned represent less than a fair commercial return upon the capital actually employed in the business, something may subsequently require to be deducted from the valuer's valuation of the fixed assets in order to allow for this.

"Going concern" valuation.

As has already been mentioned (in Chapter V.), there exists in a business where the profits represent more than a commercial yield on the value of the capital actually

BUILDINGS. employed in that business, an asset known as Goodwill. A professional valuer who is called in to value the fixed assets of such a business is not required—nor is it within his province—to value the goodwill. The goodwill requires to be valued by other independent experts, as will be referred to later. But the value of the goodwill, when ascertained, is added to the sum total of the values of the other assets of the business, less the liabilities, and the resulting figure represents the value of the business as a whole.

"Bad-will." The converse also is true, namely, that if when the value of the fixed and floating assets of a business less the liabilities, on the basis of a going concern, has been arrived at, and the profits represent less than a commercial yield on the capital thus computed, there exists what may be called a "Bad-will". In other words, the value attributed to the net assets as a whole cannot be justified; and some figure must, in effect, be computed in respect of "Bad-will" and deducted from the total of the net assets, in order to arrive at the fair value of the business as a whole. It is not within the valuer's province to say what this "Bad-will" figure should be; the calculation concerns earning capacity and falls to be made by the same experts who, in other circumstances, would value the goodwill; and the matter will be found referred to later in the chapter dealing specially with Goodwill (Chapter X.).

The following illustration will, however, make the general point clear. Let it be assumed that a professional valuer values the fixed assets of a business on the basis of that business continuing to be carried on as a going concern, at £100,000, and that the floating assets of the business, less the liabilities, are valued likewise on a "going concern" basis at £50,000. The total capital employed in the business is therefore valued at £150,000.

So far as can be seen from the results of past financial

years, the future net profits of the business cannot, let it be assumed, be anticipated to amount to more than £7500 per annum, after charging a reasonable sum in respect of the owner's personal services. BUILDINGS.

In such a case the value of the net assets of the business cannot, in the light of the expected net earnings, be justified at so high a figure as £150,000, on which the net earnings of £7500 only represent 5 per cent. The valuer who values the fixed assets on a "going concern" basis cannot be expected to review the earnings; he merely has to assume that the business is earning a reasonable profit, and that it will therefore be in the interests of the owner that it should continue to be carried on as a going concern. The position, in fact, however, is that if the owner could realise the business for £150,000 he would be only too glad to do so, as he could invest the money in high-class Stock Exchange securities to yield him at least as good an income as that which he was obtaining from the business, and he would no longer be subject to the worries or cares, or his capital to the risks, inherent in all commercial concerns.

But who would give him £150,000 for the business as a whole under the circumstances? The answer is that no one would do so. The owner would therefore be faced with having to sell the business as a whole for a considerably smaller figure, or with endeavouring to dispose of the assets piecemeal in the hope that collectively they might realise a larger sum than would result from the sale of the business as a whole. But a sale of the assets piecemeal at once disposes of the "going concern" basis of the valuer's appraisal of the fixed assets. In other words, if the valuer had been asked to express an opinion as to what the fixed assets would realise if sold piecemeal, he would, in all probability, have quoted a very much smaller figure than the £100,000.

It is, of course, immaterial whether the deduction in

BUILDINGS. respect of " Bad-will " is made from the total valuation of the fixed assets or from the valuation put upon the net assets of the business as a whole; the result in either case is the same. But the difference between " going concern value " and " break-up value " is likely to be much wider in the case of fixed than in the case of floating assets, as the floating assets are, as a rule, more easy of realisation in the event of a forced sale; and the deduction for Bad-will has been referred to earlier in this paragraph as having to be made from the valuer's valuation of fixed assets, in order to bring into prominence the effect, upon a valuation of fixed assets in particular, of the probability (or possibility) that at some future date a breaking up of the business as such may occur.

It is not suggested, of course, that because the profits of a business only show a return of 5 per cent upon the " going concern " value of the net assets, the owner's obvious course is a sale of assets piecemeal—in other words, that a break-up of the business is inevitable. In the event of this last-mentioned course being adopted, the assets might, in the example quoted, only have realised, say, £60,000; and the owner would therefore be sacrificing an income of £7500 a year in return for a cash receipt of £60,000. It would clearly be to his advantage, under such circumstances, to continue to carry on the business.

Leaseholds. Where buildings are situated upon leasehold land, the valuer would require to make suitable calculations in arriving at his valuation to allow for the fact that when the lease had expired the value to the lessee would be extinguished. In this connection the question of any liability for dilapidations, etc., at the end of the lease would also require to be considered. If the lease contained an option for an extension of the period or an option to purchase the freehold on certain terms, consideration

would be given to this in making the valuation. Copies of all leases and agreements in connection with leasehold property would be furnished to the valuer by the respective parties. BUILDINGS.

An agreement or understanding should be come to with the valuer as to (1) the amount or basis of his charges, (2) the amount of detail to be furnished by him in connection with his valuations, (3) the time within which the valuations are to be completed, and (4) the certificate (and other information, if any) to be furnished by the valuer. Valuer's charges. Completion of valuation. Nature of valuer's certificate.

PLANT, MACHINERY AND OTHER FIXED AND LOOSE EQUIPMENT

PLANT AND EQUIPMENT.

The great probability is that in regard to assets falling under the above heads the parties will not be able to agree among themselves as to the values to be arrived at for amalgamation purposes, and that they will find it necessary to employ an independent expert valuer. It is possible, of course, that detailed inventories exist in each case, showing in regard to each item of Plant, etc., in existence at the date of the merger its cost and the date of its acquisition or construction; and that from such inventories depreciation could be calculated and the current value of the plant arrived at. But even in such a case, allowance would have to be made, firstly, for additional depreciation in cases where the Plant had been purchased at a time when values were on a very high level; secondly, for a possible "writing up" in value where the Plant had been acquired in pre-war times, when costs were on a much lower basis than is at present the case; and thirdly, for possible obsolescence apart from depreciation. Furthermore, a question which might have a material bearing upon current values would be the extent to which the Plant had been kept up to a high state of efficiency by

Parties may agree upon values between themselves; but probably independent valuation necessary.

Points to be considered in making valuation.

PLANT AND EQUIPMENT.

expenditure on repairs and on replacements of parts as and when needed.

Factors such as the above cannot be properly measured by calculations made as the result of book records; but an expert valuer would, in effect, take them all into consideration in making his appraisal.

Value of certificate for Prospectus and also for Insurance purposes.

The advantage of a valuation and certificate by an independent valuer for prospectus purposes has already been referred to when commenting on the valuation of buildings. Further, the detailed inventories of plant, etc., certified by the valuer may be of value in connection with fire insurance.

Same valuer to act for all parties.

Full information to be given to valuer.

As in the case of Land and Buildings, it is very necessary that the same valuer should make the appraisal for all parties, though he possibly or probably might not be the same man who was instructed to value the Land and Buildings. (He might, for example, be a specialist in the valuations of machinery.) It is necessary that the valuer should be informed of the purpose for which the valuation is required; that explicit instructions should be given him, in writing, as to the basis of the valuation—*i.e.* that of the assets forming part of a going concern, and to be appraised as between a willing buyer and a willing seller; that the amount or basis of the valuer's charges should be agreed in advance; that the time within which the valuation is to be completed should be fixed; and that an understanding should be arrived at in regard to the amount of the detailed information which the valuer is to be required to submit.

Valuer's charges.

Completion of valuation.

Period occupied by valuation.

Not infrequently the valuations of Plant and Machinery take considerable time, especially in cases where the same valuer has to make the valuation in connection with several businesses. It is true that the detailed work in connection with the valuation (such as the making out, or checking, of detailed inventories of the Plant, etc.) might be proceeded with, by the valuer's assistants, in several

PLANT AND EQUIPMENT.

businesses simultaneously; but matters such as the inspections by the valuer and the final pricing of each item cannot be expedited beyond a certain point if the valuation is to be a thorough and efficient one.

Necessity to adjust figures in case of protracted valuation.

It is obvious that whereas the valuation is to be made "as at a particular date" and the actual work must be spread over a certain period, changes in the assets in question—particularly in the case of loose equipment—must take place during the time the valuation is in progress; for example, certain additional equipment may be purchased, or existing equipment scrapped. This does not, however, offer any insuperable difficulty. Instructions would be given to the staff belonging to each business to take careful note of any such changes, in order that the valuer might make the necessary adjustments in his inventories with the object that the latter should reflect the actual position at the date as on which the valuation is deemed to have been made.

It is not at all unusual, in order that matters may not be unduly delayed, for the valuers to commence their work some weeks—or even months—in advance of the date as on which the valuation is to be made, the necessary adjustments, owing to changes in equipment, etc., being made from time to time. With a view to minimising these adjustments as far as possible, it could probably be arranged that the work in connection with the valuation of classes of assets which are subject to little change in composition—*e.g.* Land, Buildings and heavy Fixed Plant—should be commenced at the earliest date; and that the work in connection with classes of assets which are subject to change, such as loose equipment, tools, etc., should, so far as possible, be concentrated round about the date as at which the valuation is to be made.

Patterns and Drawings.

An asset closely akin to plant and equipment is that represented by working drawings, special patterns, etc. It is difficult to lay down either the basis or the means

PLANT AND EQUIPMENT.

by which these should be valued. Much must depend upon the particular circumstances of the case. It may be that items like these are so special in character that an outside professional valuer is not in a position to appraise them. In such a case the Directors of the various concerns might discuss the matter and frame a basis of appraisal, the work itself being undertaken by means of a Joint Committee.

Fixed Assets not required after amalgamation.

It may well be the case that after two or more businesses have amalgamated it may be in the best interests of the combine to "scrap" or sell certain of the works or plant and to concentrate its manufacturing processes in the remainder. The fact, however, that such a step is probable should not lead to the buildings or plant in question being valued on a "scrap" or "forced sale" basis for the purpose of arriving at the value of the business to which they belonged. They were presumably worth more than this to the owner of the business, on the basis of that business continuing to work independently; and it is on the basis of its worth as a separate entity that each business which is entering a combine usually requires to be valued.

The further point arises, of course, as to the manner in which the combine shall deal with these assets in its books. Let it be assumed that a combine took over a number of businesses, and that in the case of one of such businesses the purchase price was arrived at as follows:

Factories, Plant and Machinery	£100,000
Floating Assets, less Liabilities	15,000
Goodwill	35,000
	£150,000

Let it be assumed that shortly after the taking over, the combine decided to transfer some of the work being carried on in the Factories above referred to to other

Factories which it owned; and let it be assumed that as a result of this policy certain Factories, plant and machinery included in the above total of £100,000 at £50,000 were sold by the combine piecemeal and only realised £10,000. *Prima facie* the combine would show in its books a loss on the sale of £40,000 (namely, the book value £50,000, less realised price £10,000).

PLANT AND EQUIPMENT.

It is submitted that in circumstances like these it would not be necessary for the combine to write this so-called "loss" off to Profit and Loss Account, but that it would be justifiable to add it to the amount standing in its books in respect of "goodwill". It must be remembered, firstly, that the combine is not necessarily bound to apportion in its books the purchase price paid for each business, over the different classes of assets in strict accord with the details shown by the valuation of such business. If for any good reason the combine considers that from its point of view as the purchaser of the business in question too high a value has been placed upon one class of asset and too low a value upon another, it is at liberty to make a deduction from the one and a corresponding addition to the other. And secondly, it must be remembered that the only object of the combine in abandoning the factories in question was in order to improve its earning capacity as a whole. In theory, therefore, while destroying some of the value in certain factories and plant which it had acquired from one vendor, it is at the same time putting at least an equivalent amount of value into another business which it has acquired, this value being represented by additional earning capacity, or in other words, "goodwill".

INVESTMENTS.

INVESTMENTS (*i.e.* Stocks, Shares, Bonds, etc.)

May be of character of fixed assets, or of character of floating assets.

In the case of a Company formed to deal in investments—*i.e.* to buy and sell them—the investments constitute a floating asset, similar, for example, to the Stock-in-Trade of a Company engaged in the manufacture or merchanting of commodities. In the great majority of instances, however, the investments are not held for such a purpose; and they can then be regarded as Fixed Assets.

Securities having Stock Exchange quotations.

In cases where the investments are in securities enjoying a Stock Exchange quotation, the question of valuation presents no difficulty. In such circumstances it is usual to take the middle market price; although in circumstances where the holding is a particularly large one and the market in the security is strictly limited, there may be good reasons for taking a somewhat lower price. In the matter of accrued interest or dividend which may be included in the market price, care must be taken to see that the vendor firm or company does not get the credit for this twice over, *i.e.* once by the amount in question being included in arriving at the profits to the date of the merger, which profits would belong to the vendor, and once again in the value of the asset, *i.e.* the investment, taken over.

Independent valuation of unquoted securities.

In the case of the investment being in a security which has no market quotation, the value thereof, for amalgamation purposes, will require to be arrived at by some independent party after inspection of the Balance Sheets of the concern, and of any other data which may be available. It is usual in such instances to appoint as the independent valuer a professional accountant or a member of a firm conversant with the values of Stocks and Shares and matters incidental thereto—such as a stock broker or a member of a financial house. Or the accountant and financial expert may work in collaboration.

If the holding in question represents the whole of, or

INVESTMENTS.

Method of valuation, where interest is a controlling one.

a controlling interest in, the share capital of the company concerned, then the services of an independent professional accountant will almost certainly be required, as access would, in all probability, be had in such cases to the detailed Balance Sheets and Trading and Profit and Loss Accounts for a series of past years, and the consideration of these would be peculiarly within an accountant's province. If the holding is relatively of considerable importance, it may be necessary to value it by appraising the individual assets of the business, including goodwill; and this may involve the employment of professional surveyors to value the fixed assets, and accountants to value the goodwill—just as in the case of the main Company.

Generally speaking, the price attributed, per share, to a holding which represents a controlling interest should be higher than that attributed to a holding which only constitutes a minority interest, as in the former case the ownership carries with it the appointment of the board, the decision as to dividend distributions, and, in brief, the dictation of the financial and general policy of the concern—an advantage which may be of very considerable importance.

Many considerations involved in valuation.

Very many considerations enter into the ascertainment of the value of a shareholding; and the most important of them will be found discussed or commented upon in various parts of this book, in connection with the valuation of businesses and of the share capital of the Companies owning them. Three may be mentioned here, as relating chiefly to cases where the holding does not constitute a controlling interest.

Special regulations in Articles of Association.

The *first* point is that the Articles of Association of the company in question should be carefully perused, in order to see, *inter alia*, whether any restrictions are imposed on the sale of the shares, as, for example, where a holder who wishes to dispose of his shares must first offer

INVESTMENTS. them to another shareholder at a price fixed by the board of the company as being fair. Such restrictions obviously have a bearing upon the marketability of the shares.

Profits earned, as compared with dividends distributed.

The *second* point is that, to an appreciable degree, the value of a minority-holding as between a willing buyer and a willing seller is influenced by the rate of dividend actually paid upon such holding, as distinct from the amount of the profit available for dividend upon such holding. This consideration is of little importance in the case of a controlling interest, as the owner of the shares has then the power of deciding what proportion of the profits shall be distributed in dividend; but the minority-holder has to take what dividend the company's Board (who are controlled by the majority of the shareholders) choose to distribute, and there is no doubt but that the holder of such shares (and also any prospective purchaser thereof) looks on " cash in his pocket " in the shape of dividend as of more value than profits accumulated in the Company's coffers and not distributed.

For example, two companies may own businesses whose circumstances at a particular date (*e.g.* as to nature, assets and profits) are exactly the same. One Company may have been in the habit of distributing the whole of its profits in dividend, while the other may only have been accustomed to distribute one half of its profits, retaining the other half in the business itself. As such, the two businesses, at the particular date in question, are of exactly the same value; and consequently the total share capitals of the companies owning such businesses are of equal value. But a minority-holding in the share capital of the Company distributing all its profits in dividend would command, per share, a better price on a sale than would a minority-holding in the Company which only distributed one half of its profits.

The *third* point is that it may be necessary to take

into account the personnel of the remaining shareholders, *i.e.* as to whether the shares are spread among a number of holders or whether one party (or two or three parties between them) holds a controlling interest. In some cases (*e.g.* where the controlling interest is in powerful and reputable hands and is not used for any ulterior object) the circumstance may be a source of strength to the Company as such, and therefore of benefit to the minority shareholders; but in other instances (*e.g.* where the holders of the majority of the shares take advantage of their position to benefit other interests with which they are concerned) the reverse may be the case.

INVESTMENTS.

Personnel of remaining shareholders.

In Appendix C will be found a *pro forma* example of the method by which the value of an industrial concern is arrived at; and this example illustrates, *inter alia*, the manner in which the fixed assets are dealt with.

CHAPTER IX

FLOATING AND MISCELLANEOUS ASSETS—POINTS ARISING ON A VALUATION OF THESE FOR PURPOSES OF AN AMALGAMATION

Preliminary remarks.

As has already been mentioned (at the beginning of Chapter VIII.), the valuation of a business or undertaking for amalgamation purposes does not always entail the valuation of the fixed and floating assets as such; it may be more appropriate in some cases to value the business purely on the basis of earning capacity. The remarks in this chapter in regard to Floating Assets must not therefore be understood as applying to the cases of all businesses which require to be valued in connection with a merger, but merely to those where the circumstances dictate that the valuation of the business shall be arrived at by aggregating the values of the various classes of assets (including Goodwill, if any) and deducting therefrom the amount of the Liabilities.

Most common forms of floating assets.

The most common classes of Floating Assets are Cash at Bankers and In Hand, Book Debts, and Stock-in-Trade and Work-in-Progress.

Cash at Bankers and In Hand.

Currency bank balances.

As regards *Cash at Bankers and In Hand*, the valuation of this presents no difficulty, as the asset can presumably be taken at its face value. Where the balances are in a foreign currency, the valuation, being in sterling, will require to be made at the rate of exchange of the day in question.

It may be suggested that a currency Bank balance should be valued in sterling, *not* on the basis of the rate

of exchange prevalent on the date as at which the valuation is made but at the rates in force when the subsequent remittances to this country (to a total equal to the amount of the Bank balance) were made. In other words, the suggestion would assume that the earliest of the subsequent remittances had relation to the Bank balance, and that in consequence this basis would attribute to the currency Bank balance the exact sterling figure which it ultimately realised. CASH.

The answer to this question would be that the attempted "ear-marking" of remittances is founded on assumption rather than on fact; and that "profits and losses" due to variations in the rate of exchange subsequent to the date of valuation are incidental to the carrying on of the business during the period in question—*i.e.* the period in which the new entity and not the old one is interested in the results.

BOOK DEBTS.

Reserve for discounts and doubtful debts.

With respect to *Book Debts*, these will, of course, require to be valued at a figure arrived at after making provision for discounts allowed on payment by the debtors within the period prescribed for this purpose, and for doubtful debts. It not infrequently happens that by the time that the values of the other assets of the business have been arrived at, the great bulk of the book debts existing at the date as at which the valuation is to be made have been collected, and in such a case the ascertainment of the reserve necessary in respect of debts still uncollected is relatively easy.

Guarantee of book debts.

Speaking generally, two alternatives present themselves in regard to the valuation of Book Debts. One is that each party should guarantee the book debts of his own business as being worth exactly their book figure, the purchase price of the business being calculated accordingly; and that to whatever extent the total sum collected in respect of such debts falls short of the book

Book Debts.

figure, the deficiency shall be paid over to the new Combine by the party in question, and, conversely, to whatever extent the sum collected exceeds the book figure, the excess shall be paid over by the Combine to the owner of the business. The advantage of this method is that the Combine, in effect, takes over the book debts at their true value, *i.e.* at the sum which they ultimately realise. The other alternative is that the book debts of each business shall be valued by an independent accountant and that the value so arrived at shall be binding on all parties. The advantage of this method is that it becomes unnecessary for the new Combine to ear-mark specifically the collections on account of book debts taken over by it, *i.e.* to separate them from the collections on account of book debts arising out of subsequent trading transactions.

Broadly speaking, the first alternative is preferable where the book debts are large, the collections relatively slow, and the amount involved in the reserve for doubtful debts considerable; whereas the second alternative is more appropriate in cases where the debts as a whole are very "clean" and the collections rapid, as in such cases the necessary reserve for bad debts cannot, relatively, reach large dimensions.

The first alternative would also be preferable in cases where certain individual debts were very large, as in such cases the possible margin of error in the amount of the reserve for bad debts would be greater than where the debts were very large in number but individually of very small amount.

Amount realised as compared with amount of valuation.

The point may be raised that if a valuation of book debts be made by an independent expert, and this fixed figure taken into account in arriving at the value of the business in question, it would still be necessary for the collection of such book debts to be ear-marked and for the exact excess or deficiency (as compared with the valuation

Book Debts.

figure) to be arrived at, as such excess or deficiency would not be a profit or a loss on Revenue Account from the point of view of the party purchasing the business, but a credit or a debit to Capital Account, and that it would therefore require to be separated from the Bad Debts Account (which is an account relating to Revenue) and be carried to Capital. As a question of principle there is something to be said for this contention. On the other hand, it seems fair to argue that the amount of the over or under valuation might largely have arisen owing to circumstances taking place subsequent to the date as at which the business changed hands, that is to say, during the period when it was being operated by the purchaser. And as the business was taken over as a going concern as from a particular date, there seems a certain amount of force in the suggestion that the excess or the deficiency could not unreasonably be considered by the purchaser as being on Revenue Account. Apart, however, from the academic point of view—upon which there may well be some conflict of opinion—there is the practical point that the valuation method would only be employed in cases where the difference could only be relatively trifling; and even in such important matters as the discrimination between Capital and Revenue, some regard is had in practice to the size and importance of the figures, as "hair-splitting" is to be deprecated.

Book debts in a foreign currency.

As regards Book Debts in a foreign currency, the usual course is to value these on the basis of the rate of exchange prevailing on the date as at which the valuation is to take place. In cases where there has been a marked rise or a marked fall in the rate of exchange during the few weeks or months immediately succeeding the date of the valuation, it may be suggested that it would be fair to take this circumstance into account in valuing the debts —in other words, to take the approximate average rate of exchange during the period over which such book debts

BOOK DEBTS.

were collected and the proceeds remitted to this country, in order that the sterling figure resulting may represent the sum actually realised from the debts. This, again, is a matter upon which more than one opinion may be held. The writer is, however, of the opinion that the most logical basis, on the whole, is that of the rate of exchange as at the date of valuation. In the first place, there is, or may be, the practical difficulty of ear-marking remittances to this country as being in respect of the collection of certain debts; the collections would first remain in a currency Bank Account for a certain time and thus be mixed with moneys from other sources, and remittances from such Bank Account would only be made when a sufficiently large sum had accumulated for the purpose and was not required for the needs of the local business in the immediate or near future. In the second place, variations in the sterling value of the book debts between the time of their valuation and the time of the presumed remittance of the proceeds to this country owing to variations in the rates of exchange in the meantime, would be due to circumstances arising in the period in which the business belonged to the new Combine, and it is therefore suggested that the profit or the loss is a profit or loss which concerns the purchasing body and not the vendor. This point of principle has already been referred to in commenting on the valuation of currency Bank Balances.

STOCK-IN-TRADE.
Valuation may be made by parties themselves or by independent valuer.

Stock-in-Trade.—The Stock-in-Trade owned by businesses which require to be valued incidental to an amalgamation can either be appraised by the parties themselves or by an independent expert valuer who would act for all parties jointly.

The phrase "valued by the parties themselves" does not mean that each party would value his own stock. It would naturally be to each party's advantage that his

STOCK-IN-TRADE.

own stock should be valued at as high a figure as possible; and to leave each party to assess the value of his own stock might be putting too great a strain upon each party's fair-mindedness. A course that is not infrequently adopted is for each party to prepare a detailed inventory (in weight, quantity or number of articles) of his stock-in-trade of various classes as at the date of valuation, and for the other parties to send representatives to check or test the accuracy of this inventory. A small committee, comprised of representatives of each of the interested parties, would be formed for the purpose of giving all the necessary instructions as to the taking and checking of the stock; and this committee would subsequently price the various items in all the inventories on a uniform basis, taking, in all probability, the current market prices at the date of the valuation and making suitable deductions in respect of damaged or obsolete stock or in respect of stock not readily saleable.

Manner in which parties might check each other's valuations.

On the other hand, an inventory and valuation by the parties themselves on the above lines may impose too great a strain upon the skill of their representatives and upon the resources of their organisations, bearing in mind that each party would be preparing his own inventory at or about the time when he would be required to assist in the checking of the inventories of the other parties, and bearing also in mind that the businesses would have to be carried on in the meantime as usual, involving continuous movement in the Stocks on Hand, by reason of purchases and sales. In such cases the employment of an independent professional valuer, who with his assistants would relieve the parties of a considerable amount of this work, and would assume full responsibility for the work which he would undertake to carry out, would probably be the most satisfactory course, although attended by additional expense in the form of the valuer's charges.

Difficulties incidental to valuations by parties themselves.

STOCK-IN-TRADE.

The choice of alternatives depends upon a number of circumstances, such, for example, as whether the Stock consists of very many different classes of articles or whether much of it is uniform; whether the daily movement in the Stock—*i.e.* the changes by reason of purchases and sales—is heavy or light; whether book records have been maintained showing the receipt and disposal of the stock of each individual class, and consequently disclosing the stock which should be in hand at any time, thus constituting a valuable check on the accuracy of any inventories: and what facilities the parties themselves can furnish in regard to the making of inventories and the fixing of prices—as already referred to.

It may, of course, be the case that businesses are valued for purposes of an amalgamation as from some past date, at which date each of the parties prepared a Balance Sheet for ordinary purposes. If, in such a case, the question of amalgamation was not, at the time when the respective Stocks-in-Trade were taken and valued, in the minds of any of the parties, then it may be fair to assume that each party would take the inventory fairly and that such inventory was complete and correct: indeed, under these circumstances, the inventories would constitute the only available data and would presumably have to be relied upon. At the same time it is well to bear in mind that not infrequently the annual stocktakings of a business are not carried out with such meticulous care and accuracy as may be demanded when the figures are to be used for purposes of valuing the business in connection with a merger.

Care necessary to ensure that all stock valued has been paid for or reserved for among liabilities.

It is important that exceptional care should be taken, when stock-in-trade is valued incidental to the ascertainment of the value of a business as a whole, that nothing should be included in the inventory which has not either (*a*) been paid for prior to the date as at which the valuation is to be made, or (*b*) reserved for among the Lia-

bilities to trade creditors. Where Stock is in continuous and rapid process of change by reason of daily purchases and daily sales, it is by no means unknown, when a Balance Sheet is to be prepared, for some stock-in-trade which has not been paid for by the date of the Balance Sheet to be included as an asset without the corresponding amount being included among the Liabilities. A proper system of record efficiently maintained should enable this danger to be avoided, and especially will this be the case if the circumstances of the business are such that book records can be kept showing the weight or quantity of each class of stock which should be in hand at any one time, and if such records are in fact accurately maintained. STOCK-IN TRADE.

In connection with the valuation put upon Stock-in-Trade for purposes of valuing a business as a whole, it is necessary to remember that the valuation may differ very materially from that which would be placed—and correctly placed—upon such stock for purposes of the annual Balance Sheet to be presented to Shareholders. The usual basis on which the Stock-in-Trade on hand at a Balance-Sheet date is valued is " cost or market value, whichever is lower at the date in question ". But if this basis were adopted in regard to the Stocks owned by each of the different parties to an amalgamation, the result might be that stock of a certain class would be taken at one price in the case of one business and at a different price in the case of another business. Such a state of affairs might arise where the market value of the Stocks had been rising, and in consequence, at the date of the valuation, the cost price was, in the case of each business, lower than the market price, with the result that the cost price would be adopted by all for ordinary Balance-Sheet purposes. But the owners of one business may have bought the particular stock at a lower price than the owners of another business. For purposes of the valuation incidental to the Basis of valuation.

Stock-in Trade.

amalgamation, the stocks of all parties should clearly be valued at the current market prices at the date as at which the valuation is to be made, irrespective of whether the stocks had cost the individual owners more or less than these prices. The term "market price" means, of course, the price in the market in which the party in question is a buyer; not the market in which he is a seller. For example, the market price in the case of a wholesale cloth merchant would be the price being charged to the merchant by the manufacturer for the cloth: whereas the market price of the same cloth in the case of a retail draper would be a higher price, namely, that being charged to the draper by the wholesale merchant.

Forward contracts for purchase of stock.

In connection with valuations of Stock-in-Trade it is important to remember that in some businesses it is the practice to enter into buying contracts for deliveries at certain future dates, such arrangements being generally known as "forward contracts". While the property in the Stocks in question does not pass to the buyer at the time when the contract is made, and he therefore incurs no immediate liability to the seller, the buyer is, nevertheless, under an obligation in connection therewith, namely, the obligation to take and pay for a certain quantity of stock at a certain future date at a certain price. At any particular date these forward contracts which have been entered into in the past but are to mature in the future, may represent an asset to the buyer or they may represent a liability. If the market value of the class of Stock in question has risen in the meantime, the contracts confer a benefit on the buyer, whereas if the market value of the stock has fallen the buyer has suffered a loss—not a realised loss, it is true, but a prospective loss.

For the purpose of ordinary Balance Sheets it is usual to reserve for any prospective loss in connection with forward buying contracts, as measured on the basis

of market values at the date of the Balance Sheet, but not to take credit for any prospective profit. For the purposes, however, of a valuation Balance Sheet prepared in connection with a merger the accrued benefit, or alternatively the accrued detriment, in connection with the forward contracts will require to be measured and brought in as an asset or a liability as the case may be. STOCK-IN-TRADE.

WORK-IN-PROGRESS.

The comments which have so far been made in this chapter in regard to Stock-in-Trade have had in contemplation stock in the form in which it has been purchased by the businesses in question. There will also, however, require to be taken into account, in the case of a manufacturer, stock which has been partly or wholly "worked-up" by him—in other words, the manufactured articles which he has to sell, either in a wholly completed or in a partly completed state. In the case of businesses such as Engineering businesses, this class of stock is referred to as "Work in progress or completed".

It will be appreciated that there is no question of "market value" (*i.e.* market value to the customer) being applied to stock in process of manufacture, or stock which has only reached a certain stage of manufacture, but upon which further work requires to be expended in order to turn it into the finished article. Until such stock is completed there is no market for it; and even when it is completed, the market value is the selling price, which, as already explained, cannot be a proper basis of valuation for the stock-in-trade of the seller.

Usual basis of valuation.

The usual basis of valuation for partly manufactured stock (or work-in-progress) in connection with a valuation for amalgamation purposes is the cost thereof—subject to the reservation that the raw material (*i.e.* the purchased stock) included in the work-in-progress should be valued at the market price at the date of the valuation. Theoretically, the cost of the work-in-progress should include, in

WORK-IN-PROGRESS.

Standing charges included in value of work-in-progress.

addition to the cost of the labour directly employed upon that work, a proper proportion of indirect labour and of all the standing charges incidental to the operation of the Factory or Works—such as heating, lighting, power, rent, rates, repairs, depreciation, etc.; but in practice it is not unusual to err on the conservative side and only to include in the cost of the work-in-progress, for Balance-Sheet purposes, the cost of the direct labour expended and the materials used in connection with such work. If the business was of such a character that the work-in-progress at any time, in comparison with the annual output, was large, then the omission, from the cost of the work-in-progress, of any proportion of indirect and standing charges might err on the side of undue caution, and might be calculated to give an unduly conservative, and therefore misleading, idea of the true state of affairs. But if the work-in-progress is not particularly heavy, then the limitation of the cost thereof, for Balance-Sheet purposes, to the materials used and the direct labour expended can be supported on grounds of ordinary financial prudence.

Valuations to be on uniform and equitable basis.

In valuing the partly manufactured stock (or work-in-progress) of several businesses in connection with a merger, care must be taken to see that, for all practical purposes, the valuations are on a basis which, besides being uniform, is fair as between the various parties. As regards the raw material included in the work-in-progress, if this is valued at current market prices, the basis is clearly an equitable one. As regards the remainder of the value, the basis of including merely the direct labour expended on the material can be defended on the ground of being conservative; but it may not operate equitably between the various parties if the work-in-progress does not in each case bear approximately the same ratio to the size (*i.e.* the value) of the business. In other words, any under-valuation of an asset can only be justified if it reduces proportionately the value of each business, seeing that

(as has already been mentioned) the main object of the valuations of the businesses is to arrive at fair *relative* values, and not necessarily at actual values.

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In cases where the relative values of the work-in-progress differ widely from the relative values of the businesses as a whole, it is therefore necessary that indirect as well as direct costs should be taken into the valuation of such work. It is, perhaps, unnecessary to add that the charges of which the proper proportion would be included in the value of the work-in-progress should not include the whole of the expenditure on Revenue Account of a Factory or Works. For example, nothing should be included in respect of selling expenses, as this is not a cost of manufacture; nor should anything be included in respect of interest, as this is an expense of providing capital; neither should Income Tax be included, as this represents an appropriation of profits and not one of the charges incurred in arriving at them.

Profit earned on work-in-progress.

From what has already been said, it must not, however, be assumed that under no circumstances is it proper to value work-in-progress at a figure in excess of its cost, either for the purposes of an ordinary annual Balance Sheet, or in connection with a valuation for purposes of an amalgamation. If the work-in-progress has been undertaken in connection with an order for which the price, or the basis of the price, has been fixed, and which the customer is not in a position to cancel, and if such work has been in progress for some little time and is not inconsiderable, and if it has reached a stage at which it is possible to make some fairly close estimate as to the ultimate amount of the profit on the "job" when completed, then it is quite legitimate to take credit for a proper proportion of the anticipated profit after making due reserves for contingencies. It is impossible to dogmatise in this connection, as conditions vary very much in different cases: all that can be usefully said here is that the parties

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to an amalgamation should consider carefully the circumstances of their several businesses, and agree jointly upon a basis which seems fair to all, or alternatively, that they should leave the matter to be decided by an independent party such as a professional accountant or a professional valuer—or, possibly, to the joint decision of these two experts, as questions of accountancy as well as technical questions incidental to the particular class of business might be involved.

Circumstances in which the valuation of work-in-progress may assume very great importance are those of large contracting businesses—*e.g.* those engaged in the construction of large buildings, bridges, docks, harbours, piers, roads and the like. Under some circumstances a contract may take several years to carry out; and it would clearly be ultra-conservative to adopt the principle that no profit whatever could be taken credit for in connection with a contract (in other words, that the work-in-progress should not be valued for Balance-Sheet purposes at any figure in excess of its cost) until the contract had been completed. In cases of these large contracts the progress of the work is inspected from time to time by independent architects or surveyors, who certify as to the amount or value of the work which has been performed, and on their certificates payments to the contractor are made, representing, broadly, the proportion of the contract price applicable to the work done, less a certain percentage (frequently 10 per cent) which is deducted and retained by the party for whom the work is being carried out, until its completion, in order to provide for contingencies. It will be appreciated that these Surveyors' or Architects' certificates define or indicate a basis on which the contractor may from time to time take credit for a portion of his anticipated profit while the work is still in progress. On the other hand, there may be special features of the contract, or special risks incidental

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to it, which may make it very difficult for any substantial portion of the profit to be taken credit for before the contract is finished.

In connection with the valuation of stock or work-in-progress which forms one of the assets of a business which is being acquired in connection with an amalgamation, a point which may occur to the reader is that the value put upon that asset may have a very material bearing upon the disclosed profits of the first financial year of the combine. If, for example, such stock were brought in to the debit of the trading account on a very conservative basis (*i.e.* at a very low figure), and a less conservative basis were adopted for the purpose of valuing the stock on hand at the end of the financial year (which stock would be brought in to the credit of the year's trading account), the profits of the year would be overstated. Similarly, if the stock taken over by the combine were valued for amalgamation purposes on a generous basis, and a more conservative basis were adopted in valuing the stock on hand at the end of the financial year, the profits of the year would be understated.

It is submitted, however, that, in circumstances where the stock taken over by the combine has been valued on a special basis, with the particular object of arriving at the relative values of the businesses interested in the merger, it may be justifiable to depart from that value for the purposes of the first trading account of the combine. In other words, it may conceivably be fair and proper, for this particular purpose, to depart from the basis on which the several assets of a business have been valued for the purpose of arriving at the value of the business as a whole (relative to the values of the other businesses) and to redistribute the value between the different classes of assets involved—as, for example, by adding something to the value attributed to the stock-

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in-trade and deducting something from the value attributed to the goodwill. More than this cannot usefully be said; a case must be examined and decided upon in the light of its particular circumstances.

There have now been dealt with in this chapter the most common classes of floating assets, namely:

Cash at Bankers and In Hand,
Book Debts, and
Stock-in-Trade and Work-in-Progress.

As will, however, be appreciated, there are a number of other assets or items of the character of assets which have not yet been referred to, apart from Fixed Assets, which have been dealt with in Chapter VIII., and Goodwill, which will be dealt with in Chapter X.

Some of these asset items may clearly be called Floating Assets, and should therefore be referred to—if it be necessary to refer to them at all—in this chapter. Others may not be strictly classified as Floating Assets; but nevertheless it has been thought more convenient to allude to them here than elsewhere. Comments on each class of asset will consequently be found below under the appropriate head.

Bills Receivable.

Bills Receivable.—Somewhat similar considerations apply to valuing Bills Receivable as to valuing Book Debts. In a large number of cases the Bills, being current for comparatively short periods, would have either been paid off or renewed by the date when the valuation of the businesses as a whole requires to be completed: in the case of collection the question of valuation will have been solved, while in the case of renewal the circumstances relating to the renewal can be inquired into with a view to seeing whether any reserve should be made in respect of a possible doubtful debt. Discounts will require to be reserved for: in other words, the present value of a Bill

Reserve for discounts.

Receivable, due for maturity at some fixed future date, must always be lower than the face value of the Bill. In cases where book debts are guaranteed by the owner of the business being valued, a similar guarantee would doubtless be given in regard to Bills Receivable, in which event no valuation of the Bills requires to be made.

BILLS RECEIVABLE.

PAYMENTS IN ADVANCE.

"*Payments in Advance*"—i.e. *Expenditure made for the benefit of a future period.*—It is almost invariably found, when assessing the value of a business or undertaking as at a particular date, that certain payments for expenses have been made prior to such date, but which relate (in part or in whole) to the period subsequent to that date. Examples of such payments are those for local Rates, and for Fire Insurance.

To the extent to which these payments relate to the period subsequent to the date of valuation, they form no charge in arriving at the earnings of the business up to that date, but are proper charges to the Profit and Loss Account of the subsequent period, *i.e.* the period in which the new combination is interested. Consequently it is fair that that proportion of the payments should be considered, as at the date of valuation, as an asset of the business to be valued for purposes of the merger. The valuation of these payments in advance is not, as will be appreciated, a question of opinion, but merely a question of mathematics: it usually presents no difficulty and consequently calls for no comment.

ADVERTISING EXPENDITURE.

Of a somewhat similar nature is *Advertising Expenditure*—*i.e.* expenditure incurred by the undertaking prior to the date of valuation, but expected to be of benefit to the concern over some period subsequent to that date. In principle the expenditure may be similar to that upon, for example, Fire Insurances: but the treatment which it calls for may be quite dissimilar, as very different considerations are involved.

ADVERTISING EXPENDITURE.
Normal advertising expenditure.

Generally speaking, it may be fair to say that in regard to a business which depends for its maintenance partly or wholly upon advertising, there must, on any given date, be expenditure which has been incurred in the past, but of which the past cannot have reaped the benefit, as some period must elapse between the time when the advertisement appears and the time when the response to that advertisement is received. On the other hand, it is the very general practice among businesses which have to incur continuous expenditure upon advertising to write such expenditure off to Profit and Loss Account as and when incurred, and not to "hold up" in their Balance Sheets any portion of it as representing an asset, or, in other words, a benefit to be reaped in a future period. Exceptions to this general practice not infrequently occur: but they are as a rule confined either to cases where the advertising expenditure is represented by assets of a somewhat permanent character (as, for example, hoardings, notice boards, sky-signs) or to cases where an *exceptional* advertising campaign is conducted over a comparatively limited period. In such circumstances the expenditure, instead of being written off direct to Profit and Loss Account as a working expense, may be charged as an expense over a period of, say, one, two or three years, the amount still remaining to be charged off at the date of any Balance Sheet being held up as a special item on the assets side of such Balance Sheet.

Semi-permanent or abnormal advertising expenditure.

In cases of valuations for amalgamation purposes, a practice similar to the ordinary commercial practice is usually followed. In other words, if there is no evidence to show that the advertising expenditure incurred by any of the businesses involved during, say, the two or three years preceding the date of the valuation is exceptional, but that, on the contrary, the circumstances indicate that the expenditure is normal, no portion thereof would be taken as an asset in valuing a business as a

whole. A case might, of course, be made out for giving one business some special consideration in this connection, as compared with the other parties to the merger—if, for example, it were found that in proportion to its profits that business was in the habit of spending very considerably more in advertising than were the other businesses. In such circumstances it would be clear that this "past expenditure for the benefit of the future" must, in the case of that business, represent a greater relative value than in the case of the other businesses. As already indicated, however, this preferential consideration would be unusual.

ADVERTISING EXPENDITURE.

When, however, exceptional advertising expenditure is clearly shown, special consideration must be given therefor. What should be the extent of this consideration—or, in other words, how much of this expenditure should be considered as relating to the period commencing from the date of the valuation—is a matter for decision in the light of all the circumstances of the case. Generally speaking, this question is left for the decision of an independent expert—such as the independent accountant who would be called in to decide other matters in connection with the amalgamation, as, for example, certain of the matters incidental to the valuation of the Goodwill.

And where advertising expenditure is represented by objects of a semi-permanent nature, such as notice boards and sky-signs, it is clear that these should be treated as an asset, *i.e.* valued at some figure less than their original cost, and arrived at after estimating their future effective life. The difference between expenditure upon notice boards and hoardings and expenditure upon—for example—advertisements in newspapers or periodicals, is that the latter can only be the direct means of attracting the attention of new customers during the period when the newspaper or periodical is being read, which may be one of only a few days; whereas the notice board or

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hoarding may attract new customers for a number of years.

Incidental to the question of permanent or semi-permanent advertisements, it is important to ensure that the same asset is not valued twice over, *i.e.* once as "equipment" by the independent surveyor, and once as "advertising expenditure in advance" by the independent accountant.

It is perhaps unnecessary to add that expenditure on advertising matter (such as handbills, booklets, etc.) which has not yet been circulated can legitimately, and in fact should, be valued as an asset. Such valuation would probably be made at the same time as that of stationery.

CAPITAL DUTY ON UNISSUED CAPITAL.

Capital Duty paid on unissued Share Capital.—It may be that a Company which is a party to an amalgamation and which is to continue to exist in the future (either as an operating Company or a Holding Company, or in both rôles together) has a larger authorised or created Share Capital than it has actually issued, and has consequently received no benefit in respect of the Duty which it has paid on the portion of its Capital which has not yet been issued.

This Capital Duty on unissued Capital may have been written off to Profit and Loss Account in the past, or it may still be held up as an item in the Balance Sheet of the Company in question. The question arises as to whether it should be valued (and if so on what basis) in arriving at the total value of the business owned by the Company in question.

This is a matter on which it is not possible to lay down a hard-and-fast rule. In the great majority of cases, however, no value would be attributed to the Duty so paid. In the first place, there may be no probability that such Share Capital will ever require to be issued: or, again, although circumstances may arise which may

render an issue expedient, it may be unlikely that the issue will require to be made for a number of years to come. Under the first-mentioned condition there would obviously be no justification for any value being attributed to the Duty: and under the second-mentioned condition, the practical difficulty arises of assessing the period, bearing in mind that the value of the duty would have to be arrived at by a process of discounting back to present values. It is suggested that the only circumstances which might justify a value being put upon the Duty would be where there was a certainty, or an extreme probability, at the time of the merger, that the capital would require to be issued in the near future. In cases where the valuation is justified, it is well to remember that the rate of Duty on the authorised share capital of a Limited Company, which was formerly 5s. per cent, was raised in 1920 to £1 per cent. The basis of the calculation, for purposes of a valuation in connection with a merger at the present time, would be the rate of duty now in force, which might not necessarily be the rate actually paid in the past.

CAPITAL DUTY ON UNISSUED CAPITAL.

Payments for Valuable Rights or under Valuable Contracts.—It may be the case that among the assets of a business which may require to be valued incidental to an amalgamation are valuable rights or contracts for which payments have been made or in connection with which expenditure has been incurred. It is clear that the value of the business as a whole must include the values of such rights or contracts: and the first question to be considered is whether the values residing in such assets have, in effect, been taken into account in arriving at the value of the other assets of the business, or whether they require to be arrived at separately. If they are to be valued separately, the further question arises as to the basis of the valuation.

PAYMENTS FOR VALUABLE RIGHTS.

PAYMENTS FOR VALUABLE RIGHTS.

In a considerable number of cases the values of special contracts or rights will already have been taken into account in the value attributed to Goodwill. The contracts or rights, in such a case, would have represented the source of certain of the income of the business, or would indirectly have swelled the net profits, and the net profits of a series of past years would, in the great majority of cases, form the foundation for the calculations by which the value of the Goodwill of the business is arrived at. Under such a category would or might be included the values residing in Patents and Trade Marks.

Patents and Trade Marks.

Unexecuted orders in hand.

The owners of businesses to be merged have occasionally suggested that among the assets to be separately valued should be the unexecuted orders on hand at the date of the valuation; the argument being based on the knowledge that such orders will, in all probability, result, subsequently, in a substantial profit. If the orders, either in volume or in regard to the anticipated profits thereon, are exceptional, some special value may, perhaps, be fairly attributed thereto. Under ordinary circumstances, however, the value of the orders is, in effect, taken into account in the value of the Goodwill, as, were there no orders in hand and unexecuted at the date of the valuation, it is only fair to assume that the profits which the business would expect to earn in the immediate future would, in relation to the past profits, be poor: and presumably the past profits have already been taken as a guide for measuring the future earning capacity, on which basis the value of the Goodwill has been computed.

Contracts in respect of forward purchase of stock.

Then, again, any valuable contracts in respect of the forward purchase of stock-in-trade would, as mentioned earlier in this chapter, be taken into account in the value put upon the stock-in-trade as a whole.

There may, however, be instances where considerable payments have been made upon or considerable expendi-

ture incurred in connection with beneficial rights or contracts of an exceptional nature, prior to the date of the valuation, but where little or no benefit has been reaped, or could be expected to have been reaped, during the period ended on that date. An example of this character might be payments for concessions such as Mining Concessions. In these cases some separate value would require to be attributed to this asset. The fair value might be more than, or it might be less than, the total expenditure actually made: this would depend upon the prospects, so far as they could be assessed at the time when the valuation was made. The parties to the merger might, perhaps, be able to decide the fair value between themselves: but in default of this, the only alternative would be for them to agree that all the relevant facts should be placed before an independent expert whose decision should be final and binding.

PAYMENTS FOR VALUABLE RIGHTS.

Payments for concessions.

It is important that in cases of assets of a somewhat intangible character, such as those contemplated above, each of the parties to the merger should supply to the other parties a list of such assets which he considers to be of value and which he claims should be separately appraised. By this means all the parties would be afforded an opportunity of considering the questions carefully in principle, with a view to each being satisfied that uniformity of treatment in regard to such matters was being preserved as between one business and another.

Parties to exchange information as to miscellaneous assets to be valued.

CHAPTER X

GOODWILL—POINTS ARISING ON A VALUATION THEREOF FOR PURPOSES OF AN AMALGAMATION

Definitions of Goodwill.

MANY definitions of Goodwill exist or have been attempted.

Lord Macnaghten (in Inland Revenue Commissioners *v.* Muller & Co.'s Margarine (1901)) said:

> What is Goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old-established business from a new business at its first start.

Mr. P. D. Leake in his book on *Commercial Goodwill*[1] writes as follows:

> An amount paid for the purchase of Goodwill really represents a premium paid to secure an extra profitable opening for the employment of Capital. The transaction may be compared with the premium paid for the purchase of a lease of premises the annual value of which is greater than the annual rent which is payable under that lease. . . . There seems to be no doubt about the truth of the proposition that before it is possible to justify value being put upon the goodwill of any Undertaking it must be shown that the expected future annual profits exceed the normal annual wage or hire of the capital invested, having regard to the nature of the risk.

Professor Dicksee in his work entitled *Goodwill and its Treatment in Accounts*[2] says:

[1] Pitman.

[2] Gee.

It is important to remember that when a man pays for Goodwill he pays for something which places him in the position of being able to earn more money than he would be able to do by his own unaided exertions.

In another part of the same book he writes :

With regard to the question as to how Goodwill is to be valued, an enormous number of circumstances have to be taken into consideration before the value of the Goodwill of any particular Undertaking can be arrived at, and, further, the circumstances which are of importance in one case are by no means invariably the same as those which require to be considered in another. There are, however, three fundamental conditions which must always exist before it can properly be said that Goodwill is of any appreciable value, and they are that the person to whom the Goodwill passes must in all cases have

(1) The right to carry on business at the same place as that at which it was formerly carried on ;
(2) The right to use the old name, and to represent himself as the legitimate successor of the former proprietors ;
(3) The exclusive right to so represent himself (which involves an agreement between the former proprietors and their successor not to compete in the same class of business within a reasonable distance of his place of business and for a reasonable time, it being understood that the term "reasonable" in this connection must be construed after taking into consideration the precise nature of each particular class of undertaking).
(4) The full control of the books of the business, including all lists of the names and addresses of customers, etc.

As mentioned in Chapter V., Goodwill may be described as the capitalised value of the actual or prospective "super-earnings" of a business. The expression "super-earnings" means the balance of net profits after providing adequately for the remuneration of those managing the business, and after deducting a sum equal to a fair return or yield upon the capital employed in the business, the rate of such return being dependent upon "Super-earnings."

the nature of the Capital employed and the class of the business.

If, for example, the earnings of a business—say an Engineering business—after providing adequately for depreciation and after charging a reasonable sum in respect of the active services of the proprietor, only amounted to seven or eight per cent on the value of the Capital employed in that business, and if there was no strong probability of the earnings materially exceeding that level in the future, no Goodwill of the business could be said to exist. The owner could not sell the business as a going concern for a higher figure than the value of the Capital embarked in it. In fact, after taking into account the risks inseparable from the business, and the possible difficulty of disposing of the business quickly for cash, should he at any time desire to do so, the owner might well feel that it would be preferable for him to take the first available opportunity of selling the business and investing the proceeds in good class Stock Exchange securities. He would, it is true, have to submit to some substantial reduction in income; but, on the other hand, the whole or any portion of his capital could easily be realised at any moment; and, further, his security—both from a capital and also an income point of view—would be very much improved, and his anxieties in this regard would be correspondingly lessened.

The correctness, in principle, of charging a reasonable sum in respect of the active services of a proprietor of a business, before arriving at the "super-profits", in connection with a Goodwill calculation is apparent when it is borne in mind that the proprietor could presumably command an equivalent sum for his services elsewhere; and that if he were to sell the business then, either (*a*) the remuneration in question would have to be paid by the new owners to some new party, or (*b*) the vendor would agree to continue his services to the business, in which event his

remuneration would have to be paid by the new owner, or (*c*) the new owner would, himself, give the necessary services to the business, thus preventing himself from taking and being remunerated for a post elsewhere.

Fair return for use of Capital employed.

The question as to what constitutes a fair return upon the Capital embarked in a business, before the question of "super-earnings"—and therefore of Goodwill—can be considered, depends entirely upon the circumstances of the case. In the case of an old-established business of an inherently stable character the rate would be much lower than in the case of a comparatively newly-established enterprise of a more speculative nature. For example, a business engaged in manufacturing or selling a necessity would, all other things being equal, be regarded as more stable than a business manufacturing or selling luxuries. Again, a business the bulk of whose trade was carried on with this country and the Dominions would in that particular respect be considered as more stable than a business which disposed of a large portion of its output in countries where the economic or political conditions were unsatisfactory or uncertain. Yet again, some classes of businesses are subject to cycles of prosperity and adversity, whereas other classes of businesses are not. Some businesses largely depend for their success upon the continued demand for some article which may be very much subject to the current popular taste or to the fashion of the moment. Some kinds of businesses enjoy, for geographical or other reasons, comparative freedom from competition: while other kinds of businesses may be subject to very keen competition.

As has been mentioned above, the class of the business or undertaking may not constitute the only factor in determining what is a fair return upon the Capital embarked. The character of the assets employed in the business may provide another factor. If, for example, the

assets are of such a character that in the event of the business proving unsuccessful they cannot be realised individually without a heavy loss, this might be a reason for fixing the "fair return" for purposes of calculations respecting the value of Goodwill at a somewhat high percentage on the value of the Capital employed. If, on the other hand, the assets could, if the business were discontinued, be realised individually for sums approaching their book value, the percentage rate applied to the Capital as constituting the fair return might be comparatively low.

As a practical illustration of the point above referred to, the case may be considered of two men who create new businesses in which they have to embark considerable Capital. The businesses are of an entirely different nature. The bulk of the Capital required by the one business has to be sunk in fixed assets, *i.e.* buildings of a particular type and machinery of a special character, both buildings and machinery being of little use for any other class of business. The greater part of the Capital required by the other business is Floating Capital, *i.e.* that represented by stocks and book debts, the stocks being of a standard commodity or article for which there is a ready market. If both businesses were to close down through failure, and the assets were to be realised piecemeal, a much greater loss of capital would probably be sustained by the owner of the first business than by the owner of the second. The relative importance of such a risk as this is bound to be taken into account by the owners of the two businesses: in other words, the owner of the first business, bearing in mind the contingency of a heavy loss of Capital, would expect a higher return upon his Capital during the continuance of the business than would the owner of the second business, who only has to contemplate the contingency of a moderate loss of Capital in the event of his business proving unsuccessful. In the first case, therefore, it might conceivably be fair to assume that a return

of at least 12 per cent must be shown upon the Capital employed before any question of "super-profits"—and therefore of there being any value in the Goodwill—can arise. In the second case, however, it might be that the Goodwill could be regarded as having some value as soon as the return on the Capital employed exceeded, say, 8 or 9 per cent.

As will be evident from what has been said above, it is extremely difficult to quote the approximate percentage of yield which would, on average, be fair, taking all classes of businesses together. It may, however, be said that in the vast majority of cases the rate would not be less than 6 per cent or more than 12 per cent.

How super-profits may be capitalised for purposes of computing Goodwill.

Later on in this chapter the question of the basis on which the annual "super-profits" which are estimated to be earned in the future shall be computed will be discussed. For the moment, however, it is assumed that the estimated amount of such annual super-profits has been arrived at; and it then becomes appropriate to consider how the figure in question should be capitalised, with a view to computing the value of the Goodwill.

The number of years' purchase applied to the figure of super-profits, in order to capitalise it, depends upon the security for the maintenance of such super-profits—or, in other words, the prospects of their being continued. These prospects, again, depend, or may depend, upon a large number of considerations—as for example the character and standing of the business; the extent to which it is subject to competition; the extent to which it is a monopoly or a quasi-monopoly; the probabilities of those persons who have directed its affairs in the past continuing to do so in future; the ratio which the amount of the super-profits bears to the Capital employed; the length of the tenancy of leasehold premises in which the business is carried on and which are necessary or valuable

from the point of view of the maintenance of the earning power of the business. The more stable and secure the future of the business appears to be, the higher the number of years' purchase which can be applied in capitalising the figure of super-profits.

From the point of view of arithmetic pure and simple, the usual procedure, as indicated above, is merely to multiply the figure of super-profits by a certain number, say by 3, or 4 or 7, the multiplier being chosen after careful consideration of all the circumstances of the case —*e.g.* as to the degree of security.

Sliding scale method of capitalising super-profits.

Another method which is sometimes favoured, and which has much to recommend it, is to take the super-profits in " quotas " or " blocks ", each block being equal to a figure representing a fair commercial return on the Capital actually employed in the business or undertaking; and to capitalise each block at a smaller number of years' purchase until all the super-profits are exhausted.

If, for example, the Capital employed in a business were £200,000 and the profits £53,000, and it were assumed that a fair commercial return on the employment of the Capital in that particular case was represented by 8 per cent, then the super-profits would be £37,000 (namely, £53,000 less £16,000). These super-profits might be capitalised as follows :

As to the first £16,000 (*i.e.* an amount equal to the amount of the commercial return on the Capital employed) at six years' purchase . =	£96,000
As to the next £16,000 at five years' purchase . =	80,000
As to the remaining £5000 at four years' purchase =	20,000
The total value of the Goodwill arrived at by the above means is therefore . . .	£196,000

The reason for this basis, as will be appreciated, is that the higher the super-profits in relation to the capital employed, the greater the risk that such super-profits may

not continue to be earned in full. The fact that a commercial business can continue to earn a very high rate of profit on the Capital employed implies, in the great majority of cases, either exceptional ability and skill in management or absence of competition. And continuance over a long series of years of both of these fortunate circumstances is unlikely: the human element is apt to be transitory, and continued success is likely to attract competitors. The basis is particularly appropriate where two or more businesses of the same, or similar, character are being valued in connection with a merger. If, for example, two businesses of the same character each have Capital employed totalling £100,000, but the super-profits (*i.e.* profits remaining after charging interest on Capital employed at the rate of, say, 8 per cent) of the one business amount to £5000 per annum, and of the other business to £20,000 per annum, it would probably be unfair to assume that the Goodwill of the second business was four times as valuable as the Goodwill of the first business. The very fact that the earning capacity of the second business is so high makes it more probable that by the process of economic laws—*i.e.* of supply, demand, competition and so on—such an exceptional state of affairs cannot continue for very long. It might therefore be fair to take the super-profits of each business in "blocks", each block being of £8000, *i.e.* equal to 8 per cent on the Capital employed, and to capitalise the first block at, say, five years' purchase, the second block at four years' purchase, the third block at three years' purchase, and so on.

Applying this formula, the super-profits of the first business would be capitalised as follows:

£5000—all at five years' purchase . . . =	£25,000

The super-profits of the second business would be capitalised as under:

£8000 at five years' purchase . . . . =	£40,000
£8000 at four years' purchase . . . . =	32,000
The remaining £4000 at three years' purchase . =	12,000
By this means the Goodwill of the second business is valued at	£84,000

as compared with £25,000 in the case of the first business.

Non-permanence of Goodwill.

Objections may, however, be raised, on logical grounds, to calculations such as those described, *i.e.* the applying of a multiplier to figures of super-profits, as it may be held to be tantamount to an assumption that the super-profits will continue to be earned in perpetuity. In particular, Mr. P. D. Leake, in the work already referred to, attacks the method, and it may be well to quote some of the remarks which he makes on the point:

With regard to the degree of permanence in value of goodwill it is clear that, owing to the operation of economic laws, super-profit can never exist permanently, though it may sometimes continue to arise out of an undertaking for a great number of years. One principal reason for the temporary character of super-profit is the existence of competition. Commercial competition is universal, and is constantly at work striving to secure a share in super-profit of all kinds wherever it arises, and whenever an undertaking is earning super-profit it will always tend to attract imitators. . . . On commonly accepted economic grounds, therefore, super-profit must never be treated as being in the nature of a perpetuity; it is essentially in the nature of an annuity extending over an unknown but limited period of years, and therefore the value of goodwill is not permanent.

. . . .

In the case of an established connection needing the continued attention of those possessing special personal qualifications as distinguished from ordinary business aptitude (for instance, the practice of a doctor or of a solicitor), the future annual super-profit, so far as it can be said to arise out of the already exercised personal qualifications and skill of the creator, must obviously tend to diminish rapidly in amount year by year.

Following, therefore, the principle described by Mr. Leake, it would be assumed that the super-profit declined evenly over a certain period until at the end of that period it ceased to exist. The greater the security for the continuance of the goodwill, the longer would be the period chosen. There would thus be a declining annuity; and a comparatively simple calculation shows what the present value of that declining annuity is. The rate of discount which would be applied in reducing the total annuity paid to terms of "present value" would depend upon the degree of risk that the income might not be forthcoming.

For example, if the super-profits were found to be £2200 a year, and it were thought fair to assume that the period over which super-profits would continue to be earned (arising as a result of the Goodwill existing at the date as at which it was valued and not new Goodwill arising from special efforts made subsequent to that date) was ten years:

The annuity in the first year would be £2200 less one-tenth, or	£2,000
In the second year the annuity would be . .	1,800
" third " " . .	1,600
" fourth " " . .	1,400
" fifth " " . .	1,200
" sixth " " . .	1,000
" seventh " " . .	800
" eighth " " . .	600
" ninth " " . .	400
" tenth " " . .	200
In all, therefore, the annuity would total . .	£11,000

and if this figure be discounted back to terms of present value, as at the beginning of the first year, and assuming that the annuity would have been payable at the end of each of the ten years, the present value (on the basis of a rate of discount of, say, 7 per cent) would be about £8500,

and the latter figure would be assumed to represent the value of the Goodwill.

Mr. Leake refers to the following possible objection to the method of calculation supported by him—that the goodwill of a prosperous undertaking earning large surplus profits may be worth no less now than it was when it was purchased ten or twenty years ago. His reply is to the effect that the present goodwill is, in the main, not the goodwill which was bought ten or twenty years ago, but is goodwill which has been created since.

The following comments in another part of Mr. Leake's book are of interest as having a bearing on this point:

> The continuation and maintenance of the volume of super-profit will no doubt depend on the constant exercise of enterprise and good management, and upon its not being unexpectedly threatened by a change of public taste or custom. If, however, no unfavourable conditions should arise it may be said, in the case of some world-renowned profit-seeking undertakings, that the volume of profit seems likely to arise almost in perpetuity. It is important, therefore, always to bear in mind the fact that the value of goodwill based on super-profit, even if treated as a perpetual annuity, cannot exceed ten years' purchase of the annual super-profit if interest at the rate of 10 per cent per annum be allowed on the purchase money, because on these terms the value of an annuity of £100 is practically ten times the annual super-profit. Interest at the rate of 10 per cent per annum is not, generally speaking, an excessive rate of interest to be expected by those who embark their capital in the purchase of commercial goodwill.

Mr. Leake is speaking here, of course, of a commercial business subject to competition and to ordinary business risks, and not of an undertaking having a monopoly, such as, for example, a Water Undertaking.

While agreeing, in the main, with Mr. Leake's views in regard to Goodwill, and with the mathematical means

by which he would give effect to them in valuing this asset, the writer is not sure that he accepts them *in toto* and without reservation.

Mr. Leake treats commercial goodwill as being, under all ordinary circumstances, a wasting asset. He refers, in the course of his argument, to a case where the value of the goodwill of a business is maintained over many years or even improved; but he argues that the goodwill in such a case is not the goodwill which existed when the concern may have been purchased, but Goodwill which has been created since by the efforts of the new owners and their subordinates. In effect, therefore, in instances where the value of goodwill remains constant, Mr. Leake visualises two processes being at work—one being creative and the other destructive, and the one off-setting the other.

On the other hand, it seems to the writer that not a few cases must exist where goodwill, which may have been built up by the *exceptional* skill, initiative or efforts of the former proprietor of a business, may be preserved by the current proprietor by the exercise of nothing more than *ordinary* effort or ordinary skill. For example, there may be valuable goodwill in a business which has been built up by advertising an article which has become a household word. The proprietor of the business presumably exercised, in the building up of that Goodwill, more than ordinary skill and initiative. If, however, the proprietor sells the business and a new owner comes on the scene, the latter might, it is suggested, be able to maintain the value of the goodwill by the use of no more than ordinary skill and effort. If that new proprietor had happened to create the business himself he would not possess the special qualities which would have been called for in the building up of a goodwill. Similarly, a Solicitor who has, by his skill and personality, attracted certain clients, may sell his practice to another Solicitor who

may be successful, without the exercise of any abnormal skill or special effort, in retaining the connection thus formed, and, therefore, in maintaining the value of the goodwill of the business.

Apart, however, from the above considerations, it may be argued that even if it be admitted that, in the majority of cases, Goodwill is a wasting asset, it may still be extremely difficult to fix, in each case, the date by which the value should be regarded as having disappeared. In the ordinary financial mind this factor of wastage is, in effect, given consideration to in the number of years' purchase at which super-profits are capitalised.

However, even to one who does not wholly accept Mr. Leake's basis of calculation, it yet forms a very convenient and useful means of testing the results arrived at by more simple, if possibly less logical, means.

Financial community often adopt arbitrary basis of valuation.

It is very true that, in general, the business and financial community is inclined to adopt very rough-and-ready means of valuing Goodwill. The valuation of Goodwill is, of course, incidentally comprised in the value put by the Stock Exchange (*i.e.* the Market Quotation) upon the Ordinary Shares of Limited Companies owning very successful commercial enterprises. It may safely be said that very few financial experts, in examining the position of one of such Companies with a view to forming an opinion as to whether the market value of the Ordinary Shares accurately reflected their intrinsic value, would adopt Mr. Leake's formula in regard to valuing the Goodwill. Indeed, it is doubtful whether the majority of such experts would attempt a valuation of the Goodwill by any scientific means. The main factors which would influence them would be :

(*a*) The class and general character of the businesses.

(*b*) The rate of dividend being paid on the Shares.

(*c*) Whether or not profits were being distributed "up to the hilt"

(*d*) Whether profits were rising, stationary or falling.

(*e*) What prior securities ranked in front of the Ordinary Share Capital.

(*f*) To what extent (very approximately) the Ordinary Share Capital could be considered as "covered" by "Tangible" Assets (*i.e.* by assets exclusive of Intangible Assets such as Goodwill, Patent Rights).

Without necessarily making calculations in regard to each of these factors, the financial expert would, partly by comparison with the values of the Ordinary Shares of other public Companies whose circumstances were more or less fully known to him, and partly by a highly developed "financial sense" almost amounting to instinct, arrive at a value of the Shares. And in a large number of cases it would be found that the valuation would differ very little from that which would be arrived at by applying the scientific methods in regard to the valuation of the various assets (including Goodwill) and the liabilities of the business as described in this book.

The above observations are not intended to decry the use of the scientific methods, including Mr. Leake's formula for arriving at the value of Goodwill; or to suggest that rough-and-ready methods are equally effective. In cases where the full data may not be available, the rough-and-ready method may be the only one which can be applied. But in other cases the scientific method should be taken advantage of; and if a rough-and-ready method be also applied as an alternative, it may be of value, as in the event of a considerable difference in the results arrived at by the two methods, the facts and circumstances may be sifted again in order to see where the difference chiefly arises.

The object of these remarks is to bring the fact into prominence that many unscientific methods of valuing Goodwill are often met with, and that although these

methods may result in an approximately correct figure being arrived at, they cannot be defended as being, in themselves, logical, or, to use a colloquial expression, "water-tight".

In connection with valuations of the Goodwill of businesses for purposes of amalgamations, however, unscientific methods should not be relied upon, unless the results can be proved to be approximately correct by the application of scientific methods—which, in effect, means that the latter methods have been adopted.

Comparison between number of years' purchase of super-profits, and the percentage representing the fair commercial return on Capital employed.

In considering whether the number of years' purchase of super-profits which it is sought to apply in order to arrive at the value of Goodwill is fair, it is sometimes useful to compare this with the percentage which has been taken as representing the "fair commercial return on Capital employed", as already referred to.

For example, a business may have a capital employed of £100,000, and be earning profits of £22,000.

The fair commercial return may have been taken at 9 per cent, and the years' purchase of the super-profits at six.

The profits equal to the fair commercial return are therefore £9000, leaving super-profits of £13,000, which, being capitalised at six years' purchase, result in a Goodwill figure of £78,000—the total value of the business thus being £178,000.

This valuation is equivalent to a valuation by earning capacity only, whereunder the profits are divided into two portions, one of £9000 and the other of £13,000, the £9000 being capitalised at just over eleven years' purchase and the £13,000 at six years' purchase.

With the object of throwing some light upon the question of the fairness of the valuation attributed to the Goodwill, it is appropriate to ask whether the security for the maintenance of the first £9000 of the profits is nearly

twice as good as the security for the maintenance of the remaining £13,000 of the profits; or whether the difference between the security in the two cases is greater or whether it is less. The reasons for there being a wide difference are firstly, because, in the event of a falling off in future profits, the £13,000 would have to disappear altogether before the £9000 began to be reduced; and secondly, because, if the business showed such poor results that it became expedient to sell the assets piecemeal, the tangible assets would realise some substantial sum, and the proceeds (after paying off liabilities) could be invested to produce, if not £9000 per annum, at least some part of that sum, whereas, as the Goodwill would realise nothing at all, it would be extremely unlikely that the total proceeds of the sale of the tangible assets, after discharging the liabilities, would amount to a sum which, when invested, would yield an income exceeding £9000.

Importance of making valuations on a basis which operates fairly as between the interested parties.

The contention has, before now, been put forward that it does not very much matter, in connection with an amalgamation, whether the number of years' purchase applied to the super-profits is somewhat on the high side or somewhat on the low side, so long as the same number of years' purchase is used in the case of each of the businesses which require to be valued. This argument is not infrequently coupled with the suggestion that a particularly low number of years' purchase should be applied, in order that the capitalisation of the new combine may be framed on a conservative basis.

This latter objective may be a very desirable one (and this point will be found discussed in a later chapter), but the first-mentioned contention is unsound, bearing in mind that the value of the Goodwill only forms a *part* of the value of the business, the remaining portion of the value representing Fixed Assets, and Floating Assets, less Liabilities. It may be very unfair, as

between the various parties to an amalgamation if the value attributed to the Goodwill in each case is arrived at on an ultra-conservative basis, whereas the value of the other assets is arrived at on a fair basis—*i.e.* not unduly low, but at the same time not on the liberal side. The under-valuation of the Goodwill would not matter if the Goodwill bore, in the case of each business, exactly the same ratio to the value of the other assets (less liabilities). But where the ratios differ widely, the inequality of treatment becomes very apparent. For example, the tangible assets of one business, less liabilities, may be worth £100,000, and the Goodwill of that business (valued on a fair basis) £50,000. In the case of another business, the tangible assets, less liabilities, may amount to £100,000, and the Goodwill (valued on a fair basis) to £20,000. The fair values of the businesses as a whole are therefore £150,000 and £120,000, *i.e.* in the ratio of 5 to 4, or, expressed in percentages, approximately 55½ per cent and 44½ per cent of the value of the two combined. If, however, it were decided to adopt an ultra-conservative valuation of the Goodwill, and as a result thereof the Goodwill figures quoted above were halved, the value of the first business would be taken to be £125,000 (*i.e.* £100,000 plus £25,000) and the value of the second business £110,000 (*i.e.* £100,000 plus £10,000), or, expressed in percentages, 53·2 per cent and 46·8 per cent of the value of the two combined.

Clearly this adjustment is unfair to the first-mentioned business, and if the capitalisation of the two businesses is to be cut down in order that the new figures may err on the conservative side, the adjustment should be made by a proportionate reduction from the fair value of each business *as a whole*, and not by a proportionate reduction in the figure of the goodwill of each business. The reduction required of £35,000 (namely, £25,000 plus £10,000) should therefore be applied by reducing the value of the

first business by £19,425 (namely, approximately $55\frac{1}{2}$ per cent of £35,000) and reducing the value of the second business by £15,575 (namely, $44\frac{1}{2}$ per cent of £35,000). By this means the value of the first business would be reduced to £130,575 and of the second business to £104,425, thus preserving the original proportions of $55\frac{1}{2}$ per cent and $44\frac{1}{2}$ per cent.

It is now appropriate to consider the question of how the super-profits which are to be capitalised should be arrived at. The figure to be arrived at represents, of course, the expectation, at the date of the valuation, of the future super-earning capacity of the business. Method of arriving at super-profits.

The future results cannot, of course, be a matter of fact; and a forecast has therefore to be made. Obviously the only data for such forecast lies in the facts and circumstances of the past, and it is therefore usual to adopt as a basis the results of some past period, adjusting the results, if circumstances seem to warrant it, by a suitable addition or deduction in respect of any factors bearing upon earning capacity which seem likely to affect the future to a material extent, but which have not been taken adequately into account in the past figures which have been adopted as a basis.

The ascertainment of a figure of super-profits obviously entails, firstly, the ascertainment of a figure of Net Profits, and, secondly, of a figure representing Capital employed, this latter figure being required in order that the sum representing the "fair commercial return" upon the Capital employed may be deducted from the figure of Net Profits in order to arrive at a figure of super-profits.

Firstly, then, there falls to be considered how the figure of net profits shall be ascertained. And this matter involves, firstly, the choice of the past period which shall be taken as the primary basis, and, secondly, the question

of the manner in which the profits of each of the financial periods comprised in such basic period shall be arrived at.

Choice of the period to be taken as a basis.

In regard to the choice of a period, many considerations arise; and the difficulties are not unusually enhanced where an amalgamation is concerned, as two or more businesses are involved, and what may be a fair period to take in one case may be unfair in another.

In the majority of instances, the businesses or undertakings which are the subject of an amalgamation are of the same character, and in such a case matters are usually simplified to the extent that if the earnings of a past series of years are unduly high or unduly low owing to conditions which are common to the trade and outside its control, the same factors are operating in regard to each of the businesses concerned. Such factors might, for example, be rises or falls in the price of the material or commodities which the businesses require to purchase for manufacture or for re-sale; increased or decreased competition from abroad; increase or decrease in the demand for the particular classes of product which the businesses have for disposal.

But apart from increases or decreases in profits, attributable to outside and uncontrollable circumstances, there may be, and probably will be, increases or decreases attributable to circumstances which those who administer the businesses are able to control, or which are due to conditions which may affect one or more businesses, but which may by no means be common to the trade as a whole. For example, the increases in the profits of a particular business may be due to the exceptional ability and skill on the part of those administering such business; to up-to-date methods of management; to the installation of new and improved machinery; to skilled advertising; to exceptionally good relations between

employers and employed; to exceptional skill in buying raw materials and other commodities required.

Special circumstances may require to be taken into account.

Or again, improvements or declines in profits may, in the case of one business, be due to a greater or a lesser demand on the part of the public for some article of which that business has made a speciality; or to exceptional prosperity or exceptional adversity in the particular district in which that business sells its commodities, leading to an increased, or alternatively a decreased, spending power on the part of those inhabiting such district. Examples of this kind occur when a colliery ceases to work, or when blast furnaces and steel works are closed down; or where an important steamship line changes its port of call; or where a great exhibition (such as the Wembley Exhibition) comes into being. Or it may be that a business has experienced a special set-back, owing to bad management, or owing to the initiation of a special policy which has proved unsuccessful and which can be reversed. Circumstances like these affect in a marked degree the earning capacities of certain trades and businesses; in some cases the changes are temporary only, while in other cases they are permanent or semi-permanent.

It is therefore necessary, in deciding as to what is to be a fair past period to take in regard to the calculation of super-profits (and also in deciding whether, having chosen a period, any subsequent addition to or deduction from the figure of Goodwill so arrived at should be made), to consider carefully points such as those referred to above with a view to eliminating or minimising the effect of abnormal and transitory circumstances.

Trend of profits.

An important point in this connection is the trend of the profits. If, as regards two businesses whose circumstances were otherwise very similar, it was found that in the one case the profits of each of the past few years had been steadily rising, while in the other case they had remained stationary, it might be very unfair to the first busi-

ness to base the goodwill calculations of both businesses on a figure of super-profits arrived at by taking an average of the results of the years in question; it might be necessary to base it, in the case of the businesses with the rising profits, upon the results of the last year only, namely, the best year.

Speaking very broadly, it is fair to assume, in the absence of any exceptional circumstances, that in reviewing the results of a series of past years with the object of assessing the earning capacity of the future, the last year should be considered as a better guide than the last year but one; and the last year but one a better guide than the last year but two; and so on. In other words, the further one goes back the greater the probability that many factors which then specially influenced the figures are no longer present. In conformity with this point of view, it may be appropriate to take a somewhat lengthy period—say, for example, six years—but when averaging the results of such period to give greater weight to the figures of the later years and less weight to the figures of the earlier years. Such a basis has the merit of taking into account the question of the *trend* of profits, which has already been referred to.

For example, let it be assumed that with regard to two businesses of the same character and whose circumstances are very similar, the super-profits of each of the past six years are as follows:

	Business A.	Business B.
1920	£13,000	£6,000
1921	11,000	8,000
1922	10,000	9,000
1923	9,000	11,000
1924	9,000	12,000
1925	7,000	13,000
	£59,000	£59,000
Average	£9,833	£9,833

If, in the example shown above, the results for 1920 are regarded as being of equal importance to the results of 1925 as a guide to future probabilities, then it might be suggested that the goodwill of each business was of equal value. But the obvious criticism is that what each business is doing to-day should be of much more value as an indication of the future than what it did in 1920; and further, that the continuous progress of business B would indicate to any impartial mind that the earning capacity of that business should in future be materially better than the earning capacity of business A, which has shown in the past a distinct tendency to decline.

If the two businesses are considered together, then it might seem fair to assume that the future combined profits would be equal to twice the average super-profits, *i.e.* £19,666, and to use this latter figure as a basis for calculating goodwill. If, for example, the goodwill were calculated at five years' purchase of the super-profits, it would be valued at £98,330; but it would be very unfair to assume that of this latter figure one-half, *i.e.* £49,165, related to the goodwill of business A, and £49,165 to the goodwill of business B.

On what principle, therefore, might the goodwill figure of £98,330 be apportioned? The following calculation illustrates the principle, which has already been referred to, of giving more weight to the later years and less weight to the earlier years.

Business A

1920	£13,000 × 2 = £26,000
1921	11,000 × 3 = 33,000
1922	10,000 × 4 = 40,000
1923	9,000 × 5 = 45,000
1924	9,000 × 6 = 54,000
1925	7,000 × 7 = 49,000
	£247,000

BUSINESS B

1920	£6,000 × 2 =	£12,000
1921	8,000 × 3 =	24,000
1922	9,000 × 4 =	36,000
1923	11,000 × 5 =	55,000
1924	12,000 × 6 =	72,000
1925	13,000 × 7 =	91,000
		£290,000

Totals are thus arrived at in the case of business A of £247,000, and in the case of business B of £290,000, and these totals can be expressed by the following percentages on the whole:

A	46 per cent
B	54 „
	100 per cent.

As the goodwill of both businesses combined has been assumed to be £98,330, the above calculation would give

A goodwill to business A of	£45,232
And to business B of	53,098
	£98,330

It should be noted that the above is only used as an illustration; it is not suggested that the particular sliding scale adopted is necessarily a fair one under the circumstances; it merely illustrates a principle.

Cases where past profits may be little guide to the future.

In a very extreme case, *i.e.* of a business which is rapidly rising in prosperity, or alternatively of a business which seems to be declining rapidly, there may be no question of dealing with an average of the profits of any past financial years. In fact, it may even be unfair to take the results of the last completed financial year as a guide—as this may afford too generous treatment to the declining business, and too unfavourable treatment to the progressive business. In such cases some formula may conceivably have to be adopted which takes into account the rate of progression (or, alternatively, the rate of

decline), and calculates the profits of future years on an assumption that such rate had continued. In this connection the figures of turnover of the business for each month of the last completed financial period and for each month which had elapsed in the current financial period might be of service as indicating the trend of affairs.

How the profits of the period chosen as a basis are to be arrived at.

In regard to the manner in which the profits of the years chosen as a basis are to be arrived at, no rules can conveniently be laid down which will be applicable to all cases. The comments which follow with respect to this matter must not, therefore, be considered as appropriate in every individual instance; in the great majority of cases where goodwill is valued by these means, they will, however, be found to apply.

In the first place, it must be remembered that the profits when ascertained have to be compared with the Capital employed; and in considering how the profits are to be computed, this fact must be kept prominently in mind in order that the profits as ultimately arrived at are those which have, in fact, been earned on such capital. In other words, if the earnings arising from certain assets are included in the profits, the assets must be included in the Capital employed; or, alternatively, if the earnings in question are excluded from the profits, then the assets in question must be excluded from the capital.

Income from outside investments.

For example, if there are comprised among the assets of a business which is to be valued for amalgamation purposes, certain Stock Exchange Securities (which may perhaps represent the investment of Reserve Funds), the income from these would not be included in the profits for the purposes of calculating the super-profits, nor would the investments themselves be included in the Capital employed. Again, there may be certain other assets not necessary for the carrying on of the business, such as surplus land, and this may produce little or no annual in-

come. Whatever the income from it might be, it would be excluded in arriving at the profits, and the value of the land would be excluded in arriving at the Capital employed.

The correctness of treating these classes of items in this way will be obvious from the following illustration.

Let it be assumed that there is a business which requires to be valued, and that the circumstances of such business are as follows :

Capital employed in the business, exclusive of Stock Exchange Securities	£100,000
Profits earned, exclusive of the income from the Stock Exchange Securities	20,000
Value of Stock Exchange Securities . . .	30,000
Income from Stock Exchange Securities before deduction of income tax	1,600

The net assets of this business, apart from Goodwill, are therefore worth £130,000, and if the Goodwill be valued by taking five years' purchase of the super-profits remaining over after a deduction has been made in respect of a " commercial return " on the Capital employed at the rate of, say, 8 per cent, the value of the Goodwill would be £60,000, arrived at as follows :

Profits	£20,000
Less amount of commercial return . . .	8,000
Super profits left over	£12,000
Five years' purchase of super-profits . . .	£60,000

The total value of the business is therefore £190,000, namely:

Net " tangible " assets	£130,000
Goodwill	60,000
	£190,000

The above is the correct basis of valuing the Goodwill. If, however, the alternative basis is adopted of including the income from the Stock Exchange Securities in the profits and including the value of the Investments themselves in the Capital employed, the following result would be shown :

Total Profits (*i.e.* £20,000 from the operation of the business, and £1600 representing the income on the Stock Exchange Securities) . . .	£21,600
Deduct 8% on the Capital employed of £130,000 (*i.e.* net assets, exclusive of Investments £100,000 and Investments £30,000)	10,400
Super profits	£11,200
Five years' purchase thereof, representing value of Goodwill	£56,000

It will be noted that by the last-mentioned method, that is to say, the incorrect method, a value of the Goodwill is arrived at of £56,000, whereas under the first-mentioned method a value of the goodwill is arrived at of £60,000.

It is obvious that the possession of the Stock Exchange Securities has no connection with, and should not influence, the calculations by which the value of the Goodwill is arrived at. The value of such Securities has already been taken into account in arriving at that part of the value of the business which is represented by tangible assets. The fallacy of the second method of computation is easily seen if the position is considered which would arise if the owners of the business had chosen to withdraw the investments just prior to the period which forms the basis of the calculations of profits earned and average capital employed. Had they done this, the business would obviously have been the poorer by £30,000—no more and no less—and in such an event the income from these securities could not have been included in the profits, nor could the Capital value thereof have been included in the computation of average Capital employed. The Goodwill would therefore have been calculated at the amount shown in the first, and correct, illustration, namely, £60,000. And the mere fact that the owner did not withdraw the securities in question can constitute no possible reason for suggesting that the Goodwill, instead of being worth £60,000, is only worth £56,000.

Interest on loans.

Again, in regard to interest on permanent or semi-permanent loan capital, such as Debentures, either the profits are arrived at before charging such interest and the "capital employed" is computed inclusive of the Debenture Capital (or, in other words, by taking the value of the total tangible assets and deducting the liabilities *exclusive* of the Debenture Debt); or, alternatively, the profits would be arrived at after charging Interest on Debentures and the Capital employed would be exclusive of the Debenture Capital, *i.e.* by deducting from the total assets the amount of the Debenture Debt as well as the total of the other liabilities. In this connection it might be material to have regard to the terms of the Debentures, *i.e.* as to whether they were to mature at a comparatively early date and whether, if they were so to mature, it seemed likely that they could be replaced on approximately the same terms.

In regard to interest paid on temporary loans, it is usual to charge this in arriving at the profits; the loans would therefore be treated as liabilities, that is to say, they would be deducted from the assets in computing the capital employed.

Abnormal profits or losses.

Any abnormal profits or losses not incidental to the carrying on of the business would be eliminated—as, for example, the profits realised on the sale of a Capital asset, or losses sustained as the result of a defalcation or of a fire.

Directors' remuneration.

The remuneration actually paid during the period taken as a basis, to Directors and Managing Directors, may require adjustment. In a certain case, it may be the fact that Directors and Managing Directors own a substantial portion of the business, either as partners in the case of a private firm, or as shareholders in the case of a limited Company. This fact may lead to their remuneration being fixed on an exceptionally low scale, or, alternatively, to its being fixed on a particularly liberal scale. In order to arrive at the true earning capacity of the

business, it is obviously necessary to charge in regard to Directors' and Managing Directors' remuneration such a sum as fairly represents the remuneration which would ordinarily be payable in respect of the services which such gentlemen render. The question of the adjustment of these charges may present considerable difficulty, especially where the Goodwills of several businesses have to be valued for amalgamation purposes, as it is by no means easy to arrive at a common basis which would operate fairly in every case. It may be possible to adopt as a basis a certain percentage of the profits earned in each of the years under consideration. *Prima facie*, such a basis would appear not unreasonable, but in practice it would not infrequently be found to operate inequitably, for the reason that the duties which are undertaken by Directors and Managing Directors in different businesses may vary very widely. In some businesses the time devoted to the administration of affairs by the Directors is comparatively small, being mainly confined to attendances at board meetings and perusal of correspondence and other matter forwarded to them through the post. In such a case a great deal of the administration work might be entrusted to Managing Directors or Managers. In other cases, however, it is the practice of each Director to devote a considerable portion of his time to the Company's affairs, and in such instances a Director might perform many duties which in the case of another Company might be performed by a General Manager or a Departmental Manager.

A practical method of dealing with this question of Directors' and Managing Directors' remunerations is for the parties to agree that such adjustments may be given effect to in the charges actually made under this head as may, in the opinion of a firm of independent Accountants, be necessary in order to deal fairly with the matter as between one business and another.

Expenditure upon maintenance of fixed assets.

Another class of expenditure which may call for special consideration is that upon the upkeep and maintenance of fixed assets such as Buildings, Plant and Machinery, etc. It is, of course, important that the charge which is made in arriving at the profits of the years in question should be a fair one, that is to say, one which is calculated to make good the wear and tear occurring in each year so far as such wear and tear is capable of being made good by expenditure on repairs and not by a "scrapping" of an entire asset and its renewal. It therefore becomes necessary to review whatever data exist to enable an opinion to be formed as to whether, taking the period as a whole, the maintenance charges are fair ones, or whether, arrears of maintenance expenditure which was properly attributable to some previous period has been made good during the years taken as a basis, or whether, on the other hand, the assets have been "starved" during such basic period; in other words, whether the maintenance expenditure has been allowed to fall into arrear. Some light may be thrown on this problem by comparing the total of the maintenance expenditure as between one year and another, and also by examining the composition of the expenditure in each year. This examination should obviously not only be confined to the period taken as a basis, but should extend to a series of years prior to that.

A not uncommon and, at the same time, a practical method of dealing with the situation is to allow the expert valuers who have been employed to appraise the value of the buildings, plant, etc., and who will, therefore, be aware of whether those assets have or have not been maintained in a thorough state of efficiency, to consider the question of upkeep and to review the figures both of the basic period and of a period prior to that, and to advise whether, in their opinion, the charges made in the basic period taken as a whole are fair, or whether any

(and if so what) addition to or deduction from such charges should be made.

Depreciation of Fixed Assets.

Allied to this question of maintenance is the question of depreciation of Fixed Assets, such as Buildings, Plant and Machinery. In arriving at the profits of the period taken as a basis, depreciation of such assets should of course be charged on a scale which is fair and which at the same time operates equitably as between the various parties. It is, perhaps, unnecessary to say that this depreciation should be calculated on the real values of the assets in question, and not on their book values. It is not infrequently found to be the case that one business may have written down its Buildings, Plant and Machinery in its books, a number of years previously, to such small figures that the charges which it makes in its annual accounts for submission to the proprietors are very low and bear no relation to the depreciation actually taking place during each year. If one of the parties to an amalgamation had dealt with its assets, in bygone days, on such a basis, while another had not done so but had written down its assets by an adequate, but no more than adequate, sum, it is obviously unfair that such circumstance should have any bearing on the calculations whereby the goodwills of the respective businesses are to be arrived at.

It is therefore not unusual to revise the whole of the charges for depreciation during the years in question by taking, in regard to the Land, Buildings, Plant, etc., the values placed upon these assets by a valuer at the date of the amalgamation and by "working back" the figures over the basic period by deducting from such valuation, on the appropriate dates, assets acquired during the period and by adding assets in existence at the beginning of the period, but scrapped or disposed of during such period. By this means the Assets Accounts and the

charges to Profit and Loss Account are adjusted in connection with depreciation by reference to the real facts of the case, and fair and proper figures are arrived at.

In cases of businesses where the question of depreciation is not of very great importance, and where the charges under this head have been arrived at by the various parties to the amalgamation on more or less uniform lines, it may not be necessary to adopt the special method of dealing with the matter referred to above. The case may be sufficiently met by leaving the charge made by each business in its Profit and Loss Account unadjusted, or, alternatively, by allowing as a debit the charge permitted by the Income Tax Authorities to be made in arriving at the profits for taxation purposes.

Leaseholds.

Where property is held on lease, the term and conditions of the lease must, of course, be taken into account in fixing the fair and proper sum to charge in respect of depreciation.

Expenditure on advertising.

Another class of expenditure which not infrequently requires adjustment is that on Advertising. The expenditure which should be charged in arriving at the profits for each of the years in question should represent, taking the period as a whole, the average normal expenditure and not necessarily the actual expenditure which had been incurred by each business during the period in question. For example, if an exceptional advertising campaign had been carried out just prior to the period taken as a basis, it might be necessary to charge a portion of this expenditure in arriving at the profits of each of the years in such period, on the ground that much of the benefit of the special campaign must have accrued during the basic period. Similarly, if any exceptional advertising expenditure had been incurred during the period, it might be found fair and proper to charge only a portion thereof in

arriving at the profits of the period, and to consider that some portion was properly attributable to the subsequent period and which would not therefore affect the calculations regarding Goodwill. Again, if there is any evidence that during the period taken as a basis the expenditure on advertising had fallen somewhat below the normal, it might be necessary to insert some additional charge on the grounds that the ill effects of such reduction of the advertising programme would, in part, be felt in a subsequent period, it being remembered that, while the calculations are based on the results of a past period, the results are intended to represent a forecast of the future profits.

Charges in respect of Excess Profits Duty and Munitions Levy.

An important question which frequently arose some years ago in connection with the ascertainment of profits for the purpose of calculating Goodwill was whether Munitions Levy and Excess Profits Duty should, or should not, be included as a charge. As these duties were removed some years ago, the question now becomes of less and less importance. It is, however, occasionally still the case that, in calculating Goodwill, the profits of a long series of years are taken as a basis, and in such event the question arises as to the manner in which charges for Excess Profits Duty or Munitions Levy incurred in the early years of the series should be dealt with.

It is argued by some that inasmuch as the duties have now been removed and will therefore not form a charge against future profits, they should not be debited in arriving at the profits which are intended to represent a forecast of the future. It is further pointed out that these taxes, in their incidence, frequently operated very unfairly as between one party and another, bearing in mind that they were based, to a large extent, upon what the earnings of the undertaking were in pre-war days, a level of earnings which might constitute little or no reflection of the earning capacity of the business during, or after, the

war. On the other hand, the view may fairly be taken that the more proper course is to arrive at the profits after deducting such charges. It must be remembered that during the greater part of the period when these taxes were in operation, the margin between buying prices and selling prices was exceptionally wide; that there was more than enough work for all; that consequently there was little competition in the ordinary sense that competition represents a struggle to make a fair living; and also that directly, or indirectly, the Government was the largest customer of most businesses. In many cases the Government paid an exceptionally high price for the commodities which it bought, and, broadly speaking, there is no doubt that it had in mind that, in effect, there would subsequently be a considerable adjustment of the price in its favour, by reason of the fact that profits over and above a certain standard would come back into the Exchequer through the medium of the Excess Profits Duty and Munitions Levy. It therefore seems not unfair, looking at the matter in very broad aspect, to consider the Duties as being, in part, a reduction of high selling prices, and therefore a proper charge in arriving at net profits and not, as Income Tax is, an appropriation of profits.

Corporation Profits Tax.

Another temporary tax was the Corporation Profits Tax, and there may well be a difference of opinion as to whether this tax should or should not be charged in arriving at the profits for purposes of calculating goodwill. The tax is no longer in force, and it seems very unlikely that it will ever be reimposed. It was not operative wholly at a time when trading results generally were, owing to abnormal conditions, exceptionally favourable.

Bearing these facts in mind, and also bearing in mind the fact that the charge only concerned a Limited Company and was not operative in cases of an individual or a firm owning a business, it would seem that the bulk of the

evidence is in favour of the profits being arrived at before making such a charge. This treatment would ensure equity in the case of one or more of the businesses to be merged being owned by an individual or a firm, and others being owned by limited companies.

Income Tax.

As regards income tax, the view is almost universally held that this, being legally an appropriation of profits, should not be charged in computing profits for the purpose of arriving at the value of Goodwill. In this connection it should be borne in mind that the business community, in speaking of returns upon Capital employed, has always in mind a return which is subject to Income Tax. For example, if an investment is able to be bought to give a yield of 6 per cent, this does not mean that the purchaser would obtain (*i.e.* receive in cash) 6 per cent on his money. He would receive a sum which represented 6 per cent, less Income Tax, at the appropriate rate. Similarly, where the expression "net profits of a business" is used, this is intended to represent the profit out of which the owner of the business has to meet Income Tax, and not the profit which is left to him after he has met such taxation.

Charges in respect of Pensions.

A class of expense which not infrequently calls for very special consideration in treatment in arriving at profits for the purposes now referred to is that represented by payments for, or provision in respect of, pensions.

The case may first be considered where certain pensions are being paid to ex-employees, but where the business is under no obligation, legally or morally, to continue such payments, and where no promises have been made or undertakings given to existing employees that they will, in due course, receive any pensions. It may be submitted that in a case of this kind it is not necessary to charge, in arriving at the profits of the basic period, the

pension payments actually made during that period, as these were made to employees whose connection with the business had ceased and whose services were therefore of no value during the period in question. Logically, however, this contention cannot be justified, it being remembered that the profits which are being arrived at, though relating to a past period, are intended as a forecast of the future; and it is only reasonable to suppose that in the future the pensions which were paid during the basic period will still be continued so far as the pensioners may yet be alive. And, further, it may be assumed, in the absence of special circumstances, that the policy which the business has thought fit to adopt in the past will be continued in the future, and that, as and when certain employees retire as the result of old age, pensions will be granted to them. Further than this, the policy of the proprietors of the business must, it is assumed, be known to the employees in general, and must presumably exercise some influence with them, if only sub-consciously. It seems, therefore, fair to argue that by reason of the proprietors' policy the business may be obtaining better services from the employees who would hope to receive pensions in due course, or, alternatively, that such employees might be willing to accept a somewhat lower remuneration during the period of their active service, bearing in mind the possibilities in regard to pensions.

It may not be sufficient merely to leave the net profits unadjusted in regard to the charge in respect of pensions. It may conceivably be necessary to insert some higher charge as a measure of the anticipated expense under this head in future years.

In some cases where there is no legal obligation to pay pensions, the proprietors of a business may yet have set aside, and have separately invested, a substantial sum representing a Pension Fund. In such a case the earnings

of such Fund must obviously be taken into account in one manner or another. They can either be treated as forming part of the profits of the business, in which case the full anticipated annual charge in respect of pensions must be inserted on the expenditure side of the Profit and Loss Account; or, if such Income be not included in the profits, then the calculations of the annual charge for pensions would be made after taking into account the fact that the interest on the invested moneys comprising the Fund would be available to relieve, in some measure, such charge.

In the case of a business where there is a legal liability to pay pensions, it is very necessary that the facts and circumstances should be thoroughly examined, in order to see that the proper annual charge is included in arriving at the profits. It may be that the fund has been constituted in accordance with the advice of an actuary, and that the latter has defined the annual charge which should be made against the profits in this connection; in the event, however, of no such annual charge having been computed by an actuary, it is very necessary that actuarial advice should be sought in order that the correct figure may be ascertained and inserted. It may be equally necessary for the services of the actuary to be requisitioned where a policy of pensions is in operation although no legal liabilities may exist. Where, however, there is an actual contract with, and obligation to, the individual employees, the matter is of special importance.

Valuation of Stock on Hand, in its effect upon profits.

It is perhaps hardly necessary to mention the importance of the Stock on Hand at the commencement and end of the series of years taken as a standard being valued on a uniform basis which is calculated to assist in bringing out the true profits earned during the period.

Valuation of Work-in-Progress, in its effect upon profits.

The same remark applies to the Work-in-Progress or contracts in course of completion at the beginning and end

of the period. With regard to work-in-progress, it may be the practice of a business to defer taking credit for any profit on such work until the whole of the work has been completed. This practice, while admirable from the point of view of the presentation of a conservative annual Balance Sheet to Shareholders, may operate inequitably if applied in the ascertainment of the profits of a particular period, incidental to the valuation of Goodwill. If the amount of the work-in-progress at the beginning and end of such period is approximately the same, and also if the percentage of the profit anticipated on such work is approximately equal, then the point has no significance. If, however (for example), the work-in-progress at the beginning of the period was exceptionally heavy, and was, in the main, composed of work which was then nearly completed, while at the end of the period the work-in-progress was comparatively light, then, if the work-in-progress, both at the beginning and end of the period, was valued at cost, the true profits of the period might be overstated by reason of the fact that on the completion, shortly after the commencement of the period, of the heavy work-in-progress at the opening date considerable profits would be taken credit for which might, in part, have been fairly attributed to a previous period. Much depends, of course, upon the character of the work-in-progress and the stage at which it is safe to take credit for any profit in connection therewith.

Similar remarks apply to the question of standing charges included in the value of work-in-progress. It is the conservative practice, in a number of businesses, merely to include in the cost of the work-in-progress the materials used and direct labour expended in connection therewith, and not to include any proportion of standing charges. It is, however, a fact that standing charges do enter into the true cost of work-in-progress, and an adjustment in this connection may be necessary in arriving at

the true profits of a period incidental to computing the value of the goodwill of a business.

Financial periods of different businesses may end on different dates.

It very frequently happens that the financial years of different businesses which are to be parties to an amalgamation end on different dates. In such cases, and where the same number of years are agreed upon to be taken as a basis of arriving at the "super-profits", then either the period must end with the last completed financial year of each business, or alternatively, some adjustment must be made in order that the figures concerning each business may relate to exactly the same period. Matters such as stock-takings probably preclude the profits of any past financial year being divided accurately into two portions, and therefore if adjustments are to be made they must be effected on some more or less arbitrary basis. One such possible basis is to take the sales of the "broken" period and to assume that the net profits of such broken period bear the same ratio to the sales as do the net profits of the whole year (in which such period is included) to the sales of the whole year.

Let it be assumed, for example, that business "A" is to be amalgamated with business "B", and that the financial year of business "A" ends on 31st December 1925, whereas the financial year of business "B" ends on, say, the 31st October 1925. And let it be assumed that the discussions and decisions as to the amalgamation take place in April of the next year, at which time the last Balance Sheet of business "A" would be dated the previous 31st December (*i.e.* 31st December 1925), and the last Balance Sheet of business "B" the 31st October 1925. Let it also be assumed that the basic period, for the purposes of the Goodwill calculations, has been chosen as the five years ending 31st December 1925. This decision would mean that, in regard to business "B", the figures representing the profits

of the five years to 31st October 1925 would require to be adjusted by an addition intended to represent the profits from the 1st November 1925 to 31st December 1925, and by a deduction intended to represent the profits from the 1st November to 31st December 1920. Let it be assumed that for the year to 31st October 1925 the sales of business "B" amounted to £240,000, and that the net profits amounted to 9 per cent of the sales, namely, £21,600. And let it be assumed that the sales for the months of November and December 1925 totalled £30,000. The net profits of the months of November and December 1925 would be assumed to be 9 per cent of £30,000, or £2700. A similar calculation in regard to the profits of the months of November and December 1920 (based on the sales for those two months and the percentage which the net profit for the financial year to 31st October 1920 bore to the sales of that year) discloses assumed profits of £2000. There would then be added to the figure representing the total profits of the five years to 31st October 1925 the sum of £700 (representing an addition of £2700 less a deduction of £2000), and the adjusted figure would be taken as representing the profits of the "B" Company for the five years to 31st December 1925, in order to bring the figures into line with those of the "A" Company.

Where, however, the profits of businesses do not show any marked increase or marked decline during or about the period proposed to be taken as a basis, it may be quite unnecessary to make an adjustment on the foregoing lines; the case may be properly met by merely taking the last completed financial year of each Company.

Method of preparing and checking the statements of adjusted profits.

It is not unusual, in connection with the preparation of the adjusted Profit and Loss Accounts for the purpose of computing the goodwill, for a firm of independent Accountants to be instructed to review the Accounts

(which would, in the first place, have been prepared by the parties to the amalgamation and certified by their respective auditors as being correct and in accordance with the arrangement made), in order to see that they have been drawn up in accordance with the terms of the scheme agreed between the parties, and also on lines which operate equitably as between one party and another. The independent Accountants would test the Accounts with the books, if they thought it advisable to do so, and would make any enquiries of the parties and of their auditors in regard thereto.

Abnormal items to be adjusted, if necessary.

It is not unusual for power to be given to the independent Accountants to adjust any abnormal items in the Accounts, if such be large in amount, with a view to possible inequalities as between one party and another being removed. In such a case it might be provided that all the parties (and their auditors) should be advised of any adjustments so proposed to be made, in order that they might discuss them with the independent Accountants and place before the latter their views thereon. At the same time it should be provided that the decision as to the treatment of such items must ultimately rest with the independent Accountants; otherwise an *impasse* might be reached.

Ascertainment of average capital employed.

It now remains to consider the manner in which the average capital employed during the period taken as the basis should be arrived at. As a fact, of course, the capital employed in practically any business varies in amount from day to day; it is added to by the profits which are being earned, or, alternatively, it is depleted by losses which are being sustained. Further, it is augmented by any additional capital which may be introduced into the business at any time, and it is being depleted by any withdrawals, either of capital or of profits, in cash or in kind. It will be appreciated that it is practically impos-

sible to ascertain what the daily profits or losses may be; and it is therefore usual, in arriving at the average capital employed during a financial period, for purposes of the calculations made with the object of computing the value of Goodwill, to assume that the profits or the losses accrue over each year, evenly, from day to day. With regard, however, to additions to or withdrawals of the capital employed in a business, otherwise than by the earning of profits and the sustaining of losses, such as, for example, the introduction of fresh capital or the payment of dividends, it is usual to take the exact dates of such accretions or withdrawals.

If, for example, the Capital employed in a business

at 1st January 1925 was	£100,000
and the profits earned during 1925 were .	20,000
and a dividend was disbursed on 1st October 1925 of	10,000

the average Capital employed in the business during 1925 would be calculated to be £107,500, composed as follows:

Capital at beginning of the year		£100,000
Additional Capital represented by the Profits earned during the year, computed as under:		7,500
The use of £20,000 earned evenly over the year is equivalent to the use of £20,000 for six months, which is equivalent to the use for a year of	£10,000	
The withdrawal for the last three months of the year of the dividend on £10,000 is equivalent to the withdrawal for the twelve months of	2,500	
The net addition to the Capital employed, by reason of Profits earned, less dividend distributed in the year is therefore . . .	£7,500	
Making the average Capital employed throughout the year		£107,500

It is perhaps unnecessary to mention that "Capital employed" means the tangible assets employed, less the liabilities. In other words, "Capital employed" would be exclusive of Goodwill.

Further, as already mentioned in regard to the ascertainment of the profits of the period in question, the capital employed means the real value of the assets less liabilities, and not necessarily the book values.

As regards fixed assets, such as Premises, Plant and Machinery, the real values would be arrived at by taking the fair values at the date of the amalgamation (as agreed between the parties or as certified by the independent professional valuer) and " working back " the figures to the basic period by making allowance, on the one hand, for additions to the assets during such period, and, on the other hand, for depreciation occurring and assets " scrapped " or disposed of during such period. As already mentioned (in connection with the ascertainment of profits), the figures of depreciation so dealt with would not necessarily be the same as the amounts written off in respect of depreciation in the books, but they would represent the depreciation which, it was considered, had really taken place during the period.

As regards Stock-in-Trade and Work-in-Progress, reference should be made to the remarks earlier in this chapter, and also to those in Chapter IX. It may be that where Stocks-in-Trade and Work-in-Progress have been valued on an ultra-conservative basis for purposes of the ordinary Balance Sheet, the necessary data do not exist to enable accurate adjustments to be made in order to arrive at the fair value of these assets at the beginning and end of each year comprised in the basic period. In such an event, nothing more can be done than to make some arbitrary adjustments on the basis of such evidence as may be available.

The exclusion, from the Capital employed, of certain assets which cannot be considered as being utilised in the carrying on of the business (and the income in respect of which has been excluded in computing the profits of the period in question) has already been referred to in

connection with the question of the profits. Examples of such assets are, as already mentioned, Stock Exchange securities, and surplus lands.

Similar considerations might apply in the case of capital expenditure made during the period in question but not fully remunerative immediately—as for example, the construction of a factory which might extend over a considerable period, but which would not be productive of profits until completed.

The general principles which should be a guide as to the inclusion in or exclusion from the liabilities, of liabilities for loans, have also been referred to; that is to say, that if the liability is of a permanent or semi-permanent character (such as a permanent or long-dated debenture debt) it should not be deducted in calculating the capital employed, nor should the interest be deducted in arriving at the profits earned; but if the loan be of a temporary character, it would be usual to treat it as a liability, *i.e.* to deduct it in computing the Capital employed, and in such case the interest thereon would be charged in arriving at the profits earned.

The difference in treatment as between the two classes of loans is not, as may at first sight appear, illogical. In the one case the Debenture Debt really forms part of the Capital which it is necessary to provide permanently for the needs of the business. In the other case the borrowings are, not improbably, only necessary at certain times and for special purposes, such as, for example, to finance a seasonal trade; at other times of the year it may be the case that not only are the temporary loans paid off but excessive floating capital accumulates in the form of deposits with Bankers. Were, therefore, the temporary loan to be regarded as part of the permanent Capital, and consequently not to be deducted as a liability, it would also be logical to exclude from the assets, at other periods, such of the surplus funds as were represented by Cash on

Deposit with the Bankers ; and this course would, in its turn, involve the exclusion, from the profit figures, of the interest received on such temporary deposits.

Example of valuation of goodwill.

In Appendix C will be found a *pro forma* example illustrating the manner in which the value of the Goodwill of an industrial concern is arrived at.

" Bad-will."

In Chapter VIII. reference has been made to cases where the prospective earnings of a business represent less than a fair commercial return on the tangible net assets employed in such business and valued on the basis of forming part of a going concern. Such a business, as explained in Chapter VIII., has what may be called a " Bad-will ". And the extent to which the Bad-will reduces the value of the business as a whole must be represented by a deduction from the value of the net tangible assets, as above referred to. The amount of the deduction should be calculated by ascertaining the sum by which the profits fall short of the figure representing the fair commercial return, and by applying to this figure of shortage a multiplier. In other words, the same process would be applied as in regard to the capitalisation of super-profits, except that the resulting figure, instead of being added to the total value of the net tangible assets, would be deducted from such value.

CHAPTER XI

LIABILITIES—POINTS ARISING ON THE ASCERTAINMENT THEREOF FOR PURPOSES OF AN AMALGAMATION

Guarantee of liabilities by vendor—and alternative.

As already mentioned (in Chapter V.), a very common procedure in connection with the ascertainment of the liabilities of a business (in order that the total may be deducted from the value of the total assets for purposes of arriving at the value of the business) is that the owner of the business guarantees that the liabilities are exactly equivalent to the total at which they appear in the books of account at the date of the valuation. If the liabilities are subsequently found to be in excess of their book figure, then either the owner of the business pays into the bank account of the business a sum equal to the excess, or, alternatively, the value attributed to the business for amalgamation purposes is correspondingly reduced.

The above procedure may involve a certain amount of delay; on the other hand, other matters incidental to the amalgamation—as, for example, the valuations of fixed assets—generally occupy some considerable time, and it may well be the case that when these matters have been completed the exact amount of the liabilities has been ascertained, in the light of payments to creditors made subsequent to the date of the valuation.

It will be appreciated, also, that this guarantee of liabilities (as opposed to a valuation which when once made has to be accepted as correct by all parties) involves the ear-marking of all payments taking place during the few months succeeding the date as at which the business is to be valued, as between payments in discharge of liabilities incurred up to that date and pay-

ments in respect of transactions occurring subsequent to such date. This may entail a considerable amount of clerical work.

On the other hand, it must be remembered that in some classes of businesses or undertakings it may be a matter of some difficulty to be sure, at or within, say, two or three weeks of the date of the valuation of the business, that every liability has been included, and at its correct amount. It may be argued that this task must always be undertaken when the annual Balance Sheet of the business comes to be prepared, and that it does not apparently present any great difficulty on such occasions. It must, however, be remembered that in cases where the ascertainment of the exact liabilities as at any particular date is accompanied by peculiar difficulties or exceptional labour, it is quite appropriate, for the purposes of annual Balance Sheets, to make a round-sum reserve which, though arbitrary, errs on the safe side—in other words, to over-reserve, as a precautionary measure. Further, in other cases it often happens that among the total of "Creditors and Credit Balances" in annual Balance Sheets may be included certain reserves for contingencies, or free reserves, which relieve those responsible for the Balance Sheet of the necessity of taking an inordinate amount of trouble in order to be sure that the exact amount of every liability is specifically reserved for.

In the case, however, of an ascertainment or "valuation" of liabilities in connection with the valuation of a business for amalgamation purposes, it is highly necessary that the exact amount of liabilities should be arrived at —or at least that the valuation should conform so nearly to the truth that differences could only be negligible. It will be appreciated that if the value of a business is arrived at on the basis of the liabilities being estimated or valued at a figure materially in excess of their real total, and if such valuation is adopted "for better or for worse",

the business will have been undervalued and the owner consequently prejudiced. Correspondingly, if the total adopted in respect of the liabilities be too small, the business will have been overvalued, and the owner thereof will have received an undue advantage.

Taking all considerations into account, the method of dealing with the liabilities by means of a guarantee by the owner of the business in question, and the subsequent ascertainment of the exact total and the adoption of such total as the basis, will probably be found to be the most satisfactory.

In connection with the ascertainment of the liabilities, one or two points may be mentioned which may conceivably be overlooked, or in respect of which errors may possibly be made.

Discounts allowed by creditors.

In a number of cases it is not the custom to reduce the amount of the trade liabilities for the purposes of the annual Balance Sheets by the amount of the *Discounts* which will be obtained from such creditors on settlement of their accounts within the usual credit period. For purposes, however, of a valuation of the total liabilities of a business in connection with an amalgamation, a proper deduction from the total of trade creditors should be made in this connection.

Income Tax.

Again, points needing special care and attention may occur in computing the liability in connection with *Income Tax, Schedule D*, accrued to the date as at which the valuation is to be made. In connection with the preparation of the ordinary annual Balance Sheet of a business it is by no means unusual to adopt the policy of reserving a somewhat larger sum in this respect than is strictly necessary. This precautionary measure is adopted in some cases because, at the date when the Balance Sheet is prepared, the last Income Tax assessment may not have been agreed with the Revenue Authorities, owing

to points of difference being still outstanding with the Inspector of Taxes. In other cases the over-reserve is considered prudent because the Income Tax assessment is based on the average profits of a series of past years instead of on the profits actually earned in the year of assessment; and in the absence of any "nest egg" in the shape of such an over-reserve, it may be found, in a year when the profits earned have been poor, that the charge which must be inserted in the Profit and Loss Account in respect of Income Tax, being calculated on the higher profits of past years, absorbs a very large proportion of the profits of the year in question.

For amalgamation purposes the exact liability accrued to the date of the valuation should be calculated (subject to the possible exception referred to below); and in this connection care must be taken to see that where the business recoups some of its liability to the Inland Revenue Authorities by deducting income tax in paying charges such as loan interest and debenture interest, this circumstance is taken into account. In other words, care must be taken to ensure that no portion of the liability is taken into account twice over, once in the Company's liability to the Inland Revenue Authorities, and again by reserving the gross and not the net amount of the accrued interest payable.

An exception to the rule of calculating the exact accrued liability to Income Tax to the date of valuation may be justified where, owing to the profits of the last year preceding the date of the amalgamation being exceptionally poor (or exceptionally favourable), the charge for Income Tax, by reason of being based on the profits of the past year, is exceptionally light (or exceptionally heavy). For example, two businesses which are to be merged might conceivably have net assets similar in character and value, and equal

earning power as measured by the working results of a series of past years after eliminating abnormal items. Yet one business may (owing to exceptional circumstances which have, quite properly, been disregarded in measuring the value of its goodwill) have made very small profits during the year preceding the date of amalgamation, while the other business, owing again to exceptional circumstances which are not expected to recur, may have made abnormally high profits during such year. If, as would in all probability be the case, the Inland Revenue Authorities agreed to treat the new Combine as representing a continuation of the two separate businesses, and consequently assessed it on the basis of the average profits of the two old businesses combined, the first-mentioned business, by reason of its very poor "basic" year, would be the means of lightening considerably the liability of the Combine to tax during its first year, whereas the second-mentioned business, by reason of its very good "basic" year, would be the means of increasing materially the income tax liability of the Combine. It might, for example, happen that each business during the first year's working under the new régime contributed an equal amount of profits to the Combine; but that of the income tax liability in respect of that year only one-fourth arose by reason of the inclusion (in the income tax return) of the past profit figures of the first-mentioned business, while no less than three-fourths arose as a result of the inclusion of the past profits of the second-mentioned business.

In a case such as this, it seems fair to contend that, where the differences in question are important, some addition should be made to the value of a business such as the first-named, and a corresponding reduction in the value of a business such as the second-named, bearing in mind that the one would be presenting the Combine with a benefit (or, in other words, with something which is

equivalent to an asset), while the other would be imposing upon it an additional liability.

The illustration given above presumes an amalgamation of the businesses as such—in other words, a Complete Amalgamation. But the same consideration might equally be present in the case of a Holding Company Scheme where the valuation might concern the ordinary share capital of the companies owning two businesses. In the case of the Holding Company Scheme the businesses would continue to be assessed to Income Tax as before, *i.e.* as separate entities; but any saving in Income Tax (or alternatively any increase of tax) due to the incidence of taxation as described above would be felt by the Holding Company, in that the profits which would be available for the Operating Companies to distribute to the Holding Company in dividend during the first year after the scheme became operative would be correspondingly increased or reduced.

Liabilities in connection with the payment of pensions.

It not infrequently happens (especially in large businesses or undertakings) that Pension Funds for employees have been created in the past and are in existence at the date of the contemplated merger. These Funds may have been created solely from sums set aside out of the profits of the business—in other words, sums contributed by the employer; or they may have been created partly from sums contributed by the employer and partly from sums contributed by employees. In the latter event, it would invariably be found that there was a legal liability to the employees, *i.e.* definite pension rights to which employees would be entitled; but in the former event there might or there might not be such legal liability.

The first point to discover is whether there is any legal liability in connection with the Pension Fund. If there is no legal liability—in other words, if the fund has been

accumulated solely by the employers, and the latter have not undertaken to pay any pensions out of such fund—then the assets representing the fund can be valued with the other assets in arriving at the total value of the business or undertaking. (Or, alternatively, the owner may withdraw the assets, in the shape of a drawing or dividend, in which event they would be excluded in arriving at the value of the business.) But if there is a legal liability, it becomes necessary to have the amount of such liability ascertained by actuarial calculations, as the assets representing the fund on the one hand and the actuarial liability on the other have both to be brought into account in arriving at the value of the business. It may be that an actuary has quite recently examined the Fund and made a report thereon, which sets out the actuarial reserves necessary in connection with it; and this report might furnish sufficient data for the purpose in question. In the absence, however, of such a Report the only course is to requisition the services of an actuary, who will determine the amount of the actuarial liability.

The parties to an amalgamation may conceivably be tempted to dispense with the services of an actuary in such cases on the ground that the assets of the fund are "believed to be about sufficient" to cover the accrued liability, or on the ground that the liability, whatever it is, has not immediately to be met, and that if at some future time there are indications that the assets of the Pension Fund are insufficient to meet the calls which have to be made upon them the matter can be redressed by increased appropriations out of profits to the Pension Fund. It cannot, however, be too strongly urged upon the parties that such a course is illogical and highly dangerous. In certain instances in which, to the writer's knowledge, it has been adopted the consequences have been very serious; as when the circumstances were properly examined, many years later than should have been the

case, the deficiency, at first comparatively small, had grown to alarming proportions, and special steps, detrimental to the business, had to be taken to put the Fund in a solvent position.

In referring to the question of liability, the term "legal liability" has hitherto been used. It may, however, be proper to make a reserve in cases where there is no legal liability but merely a moral liability. If, for example, a business has given its employees to understand that they may look with confidence for pensions upon reaching a certain age or upon completing a certain number of years' service, and this understanding will be honoured by the business, an actuarial reserve should be calculated. It is only fair to assume that, directly or indirectly, the business has benefited in the past by such provisions or understandings. Employees may, as a result, have been more loyal and contented; they may have accepted lower salaries or wages, having in mind their pension expectations; they may have thereby been induced to stay in the employ of the business instead of finding occupation elsewhere. And if the business were suddenly to notify its employees that it had decided to pay no pensions in future, such an announcement would presumably lead to the employees giving less valuable service in the future than they had done in the past, or alternatively, to their making demands for higher remuneration. These points support the contention that it may, under certain circumstances, be logical and proper to make the reserve even in cases where there may be no legal liability.

Similarly where a business has a number of pensioners in existence at the date of the merger, even though there may be no legal liability to continue the pensions, the actuarial liability should be calculated and deducted in arriving at the value of the business as a whole. Exception would only be made (*a*) where the proprietors of the business undertook to pay the pensions themselves in

future out of their private purses, or (*b*) where the pension payments were discontinued. Course (*b*) would be very seldom followed. It would presumably cause great hardship to the pensioners; and the knowledge that it had taken place might not be without effect upon the loyalty of the existing employees.

Sundry special liabilities.

There are also a number of special liabilities—contingent or actual—which are to be found in special classes of businesses, and which may be difficult to measure with exactness. Examples of these are:

Liability to maintain, for a certain period of time, works which have been constructed—as in the case of a Contractor who undertakes road construction work.

Accruing liability for dilapidations in connection with Leasehold Premises.

Liability under actions pending for libel—as in the case of a newspaper property.

Liability for defective work discovered by the buyer after delivery of an asset constructed or produced by the seller—as in the case of plant manufactured by an engineering business.

Liabilities in connection with onerous agreements covering certain periods.

Liabilities under guarantees.

Little can usefully be said in regard to these classes of liabilities. Each case must be dealt with on its merits.

As will be appreciated, liabilities of this character would not, or might not, appear at all in the books of account of the business.

It is perhaps unnecessary to add that each of the parties to an amalgamation would be required to supply a complete list of liabilities—actual and contingent—and

also a list of all important contracts and obligations in order that these could be reviewed by those who were charged with the duty of ascertaining the respective values of the businesses in question. Each party would also be required to state that he knew of no important circumstance detrimental to his business which would not be disclosed in the Balance Sheet, Profit and Loss Accounts, and Schedules of Assets and Liabilities, etc., submitted by him in connection with the merger.

List of liabilities to be furnished by each party.

It is not unusual, in addition, to require the auditors to each Firm or Company which is a party to an amalgamation to state that they know of no circumstances of importance, detrimental to the business, which have not been disclosed in the figures and other information submitted.

CHAPTER XII

VALUATIONS OF BUSINESSES OR UNDERTAKINGS, FOR PURPOSES OF AMALGAMATION, ON BASIS OF EARNING CAPACITY ONLY

Introductory remarks.

As mentioned in Chapter V., the extent to which the individual assets comprising a business should be valued in arriving at the value of the business as a whole, and the extent to which the earning capacity of the business should be a guide to the value of the business, depend upon the circumstances in each case, and, in particular, upon the character of the business.

Hitherto the remarks which have been made in regard to valuations of businesses have related to businesses where it is appropriate to value the individual assets including the Goodwill. It is now therefore necessary to make a few comments upon those cases where a valuation should be made entirely, or practically entirely, by reference to earning capacity.

Example of a water supply undertaking.

A simple example is that of a Water Supply Undertaking. In such a case the following features, among others, are to be noted.

Firstly, that presumably the Undertaking enjoys a monopoly or quasi-monopoly, and therefore the question of possible competition is either of very minor importance or can be ignored altogether.

Secondly, the great majority of the assets of such an Undertaking are fixed assets, and most of these are of practically no value except as forming part of the Undertaking as a going concern. For example, there would be the cost of laying Mains, the cost of the Pipes themselves, the cost of Reservoirs, Pumping Stations, etc.

In order, therefore, to compute the value of an Undertaking of this character it is necessary, in the first place, to arrive at what is commonly known as the "Maintainable Net Revenue". This latter expression is intended to mean the average profits which the Undertaking may fairly be expected to earn in the future after making allowance for adequate expenditure on Maintenance, for Depreciation, and also, in the case of an Undertaking having a concession for a limited period only, for such further charge against the profits as may be necessary to provide for any Capital loss which will be sustained when, at the end of the period of the concession, the Undertaking is handed over to those then entitled to it. The amount of such Capital loss, of course, depends upon what the terms of the concession are, *i.e.* as to whether payment is to be made by those who will ultimately acquire the undertaking, and if so, on what basis the amount so to be paid is calculated. When this figure of Maintainable Net Revenue has been computed, it is then capitalised at a certain number of years' purchase, and by this means the value of the Undertaking as a whole is arrived at.

Maintainable net revenue.

The foundation for the calculations whereby the maintainable net revenue is assessed is, of course, the figures showing the operating results of a past period. The period to be so chosen depends, of course, on the circumstances of the case. But in any event the profits as shown by the results of such period will require adjustment in order to make due allowance for capital expenditure which, though made prior to or during such period, had not yet become fully remunerative; and also for capital expenditure which, though remunerative as soon as it was incurred, was not in existence during the whole of the period taken as the basis.

The past profits form the foundation for the calculations.

The method of valuation has been described above very broadly and very briefly. Many special points may require to be dealt with in individual cases, but it is

hardly practicable to make any useful comments in regard to these. Each case must be dealt with on its merits.

Provision for amortisation of capital.

It will be appreciated, on a little reflection, that the question of the provision which should be made (in the form of a charge in arriving at the profits) in order to allow for the Capital loss at the end of a concession, may involve a number of intricate points, especially when, as is not infrequently the case, the exact manner in which the sum to be paid by the party, or body, taking over the Undertaking is not made perfectly clear, and will therefore ultimately have to be settled as the result of a formal enquiry such as an arbitration. A noteworthy case of this character was that of the National Telephone Company, when the conflict raged round the question whether, in arriving at what was known as the " then value " of the assets (*i.e.* their cost less depreciation), the depreciation was to be calculated on what is known as the " straight line method ", or on the " sinking fund method ". The " straight line method ", it may be explained, is the usual one of charging to Profit and Loss Account each year a fixed proportion of the original cost of the asset; while the sinking fund method modifies the incidence of the charge as between one year and another by taking into consideration the fact that the sums written off in respect of depreciation are represented, in some shape or form, by assets, which assets are presumably revenue-producing and therefore increase the profits.

Question of future expansion of net revenue.

Another point not specifically referred to above, which has to be taken into account in making the valuation and which necessitates intricate calculations, is that of the anticipated expansion of the undertaking (and therefore of its net profits) in the future, the question being whether the possibilities or probabilities of future expansion have a definite value at the time when the appraisal of the business is made. The expansion of an Undertaking such as a Water Undertaking implies, of course, the provision

of further Capital. If the increased earnings attributable to such expansion are not anticipated to be higher than the interest or dividend which has to be paid on the Debenture or Share Capital which will have to be raised in order to provide for such expenditure, then obviously the Undertaking, on the date of the valuation, is no more valuable on that account. If, however, such earnings are expected to be sufficient to pay the interest and dividends in question and to leave some surplus over, this surplus would have enured for the benefit of those who owned the Undertaking at the date of the valuation. In other words, such owners can look forward to a future benefit, and this future benefit must have a present value. Broadly speaking, therefore, the calculation has to take the form of ascertaining what this future benefit may reasonably be expected to amount to in each future year, and then to discount this benefit back to terms of present value, *i.e.* as at the date of the valuation.

If the valuations concern two or more Undertakings and are required for purposes of arranging the terms of amalgamation, then if all the Undertakings are expanding in a similar ratio the importance of the above point becomes very much modified, bearing in mind that it is the relative rather than the actual value of each Undertaking which has to be ascertained.

Example of a colliery property.

Another class of Undertaking which must be valued practically entirely on the basis of prospective earning capacity is a Mining Property, such as a Colliery. Such Undertakings have two special features. In the first place, their life is limited by the quantity of mineral available for extraction, and secondly, the Capital employed is represented by assets and expenditure of which the value practically disappears when the Mine becomes an uneconomic proposition. A mining shaft, when the mine is no longer profitable, becomes nothing more than a hole

in the ground. And even assets such as Land, Buildings and Plant, may have little value when the Mine is exhausted, although, physically, the buildings and plant may still be in quite a good condition. It will thus be appreciated that, in valuing a Mining Property, the usual distinction between what may be called "tangible" assets on the one hand and Goodwill on the other is not appropriate. What the purchaser of a Mining Property is buying is the right to receive, over a series of future years, the excess of the proceeds of the sale of the mineral which was in the Mine at the date of purchase, over and above the future costs of extracting such mineral. It means little to him how much of the expenditure which he would have to incur would be represented by, for instance, the sinking of a shaft, and how much by the actual cost of extracting the mineral. Both classes of expenditure equally represent the cost of getting at the mineral and have to be set against the proceeds of the sale of such mineral—either as and when incurred or apportioned over the life of the Mine. If, at the time when a Mine is acquired, expenditure has already been incurred on the sinking of a shaft and on Buildings and Plant, there is obviously correspondingly less expenditure to be incurred in the future under this head: the expected future annual profit (*i.e.* the excess of the proceeds of the sale of the mineral over the future cost of winning it) is thereby greater; and the Mine is correspondingly more valuable. In effect, therefore, past expenditure on fixed assets and on development is fairly taken into account in a valuation of the Undertaking as a whole, although such valuation is arrived at solely on the basis of earning capacity.

As already mentioned, the purchaser of a Mining property is buying the right to receive certain surpluses over a series of future years. The consideration which he should pay in respect of such surpluses (in other words, the fair value of the Mining Property) would not, of course,

represent a sum equal to the total of the surpluses, as such surpluses are not immediately receivable but are spread over a period. It is therefore necessary to have regard to the period over which such surpluses are expected to be earned, and to discount the surpluses back to present values.

Perhaps one or two simple examples will serve to illustrate the method of calculation described above.

Example (*a*).—Let it be assumed that a Colliery is for sale and that the unworked coal is estimated at 30 million tons; that the normal output will be 1 million tons per annum; and that therefore the Colliery will have a future life of thirty years. Let it also be assumed that the excess of the selling value of the coal in future, over and above the total future costs of development and extraction, amounts to 1s. 6d. a ton, and that this rate of excess is earned evenly over the whole life of the Colliery.

A purchaser of the Colliery would then receive at the end of each of the next thirty years 1,000,000 × 1s. 6d., or £75,000. He could ascertain by calculations that if he set aside £11,500 a year out of this income, and accumulated it at compound interest at, say, 4 per cent, it would amount at the end of thirty years to about £645,000. If he paid £645,000 for the Colliery, he would receive each year (after setting aside the Sinking Fund of £11,500) £63,500, which would represent practically 10 per cent on the purchase price (and which may perhaps be considered a fair return having regard to the risk involved); and when the Colliery was exhausted he would receive his Capital back in the form of the securities in which the Sinking Fund was invested.

Example (*b*).—Let it be assumed that another Colliery is for sale whose circumstances are identical with those of the Colliery under Example (*a*), except that the output is anticipated to be 2,000,000 tons per annum,

and therefore the future life is fifteen instead of thirty years.

The purchaser would receive an annual sum of £150,000 (*i.e.* 2,000,000 × 1s. 6d.) at the end of each of the next fifteen years.

If he set aside £50,000 of this annual sum, and invested it at compound interest at 4 per cent, it would amount at the end of the fifteen years to about £1,000,000.

If he paid £1,000,000 for the Colliery he would receive per annum (after meeting the Sinking Fund of £50,000) £100,000, which would represent 10 per cent on the purchase price—which was assumed under Example (*a*) to be a not unfair return—and when the Colliery was exhausted he would receive his Capital back in the form of the securities in which the Sinking Fund was invested.

It should be mentioned here that the illustrations set out above must not be read too literally; they have been given in the simplest form in order to illustrate the general principle. For example, it must be remembered that when one speaks of a 10 per cent yield one means 10 per cent, subject to Income Tax—that is to say, one is referring to profits before deducting Income Tax. When, however, one considers profits to be allocated annually to a Sinking Fund one is speaking of profits after deduction of Income Tax: in other words, Income Tax has first to be provided in connection with such allocation in order that the amount of the allocation may represent cash actually available for investment for Sinking Fund purposes.

Valuation of a colliery involves examination by mining expert.

It will be appreciated that in order to provide the data on which calculations such as the above can be founded, an examination of the property by a Mining Expert would be necessary, and there should also be available to such

expert the figures showing the results of past working. The expert would, *inter alia*, have to estimate the quantity and quality of the mineral remaining in the Mine; the development expenditure necessary from time to time to extend the Mine in order to reach such of the mineral as could be worked at a profit; and the estimated costs of extracting the mineral. The average selling price obtainable for the mineral in future will also have to be estimated; and a further estimate will have to be made as to the length of time over which this mineral will be extracted, and also in regard to whether the process of extracting will be spread more or less evenly over the period concerned.

Amortisation of future development expenditure.

In arriving at the anticipated future profits in cases where Development Expenditure has yet to be incurred, there would require to be debited as one of the costs a sum sufficient to amortise such development expenditure over the estimated future life of the portion of the mine to which it related, and also a sum representing interest upon the amount of the future development expenditure. The reason for this charge having to be made will be appreciated when the following simple example is considered:

Let it be assumed that an unworked Mine is for sale; that development expenditure to be immediately incurred by the purchaser is estimated at £1,000,000; that the life of the Mine is twenty years, and that the excess of the sales of the mineral over working costs is estimated at £100,000 per annum. In considering what, if anything, he should pay for the unworked Mine, the prospective purchaser has to remember that, out of the £100,000 a year he will have to provide for the amortisation of the development expenditure of £1,000,000 which he has to incur as soon as he has completed his purchase—in other words, he has to make provision for the return of his £1,000,000 at the end of twenty years before he can consider any question of "net profits". If the profits

left, after providing the Sinking Fund for the £1,000,000, represent no more than an ordinary commercial return on the £1,000,000 (and in this case they would not do so, as the Sinking Fund provision, on a 4 per cent basis, would require about £33,000 per annum, leaving only profits of £67,000 per annum, or 6¾ per cent on the £1,000,000), it is obvious that the unworked Mine is of no value—that is to say, that it will not yield an adequate return on the cost of developing it, as 6¾ per cent cannot be considered as a sufficiently high yield on Capital employed in a Mining Undertaking.

It must be understood that the method of valuation described above in connection with a Mining Property is only dealt with in very broad outline; to attempt to do more would be impracticable, as circumstances vary very widely in different cases.

CHAPTER XIII

CAPITALISATION OF LIMITED COMPANIES IN CONNECTION WITH AMALGAMATIONS

Preliminary remarks.

At a time when an amalgamation is arranged, important decisions have often to be taken in regard to the capitalisation of one or more Limited Companies. The matter may be one which involves existing Companies only, *i.e.* as to possible rearrangement of the Capital or alterations in the rights pertaining thereto; or it may merely concern a new Limited Company to be formed incidental to the amalgamation. Or, again, it may concern both an existing Company and a new Company.

Definition of "capitalisation".

By the term "Capitalisation" is meant, firstly, the total of the Capital, and secondly, how that total is to be represented, *i.e.* whether by Ordinary Shares only or whether by some form of Preference Capital as well; or, again, whether part of the Capital is to be represented by Loan Capital such as Debentures. If more than one form of Capital is desired, then the question arises as to the rights which each class of Capital shall enjoy, *i.e.* as to the rate of interest or dividend; as to the security from a Capital point of view; as to voting; and as to redeemability.

Capitalisation of existing companies.

It will be understood that where existing Companies are concerned which are not to be placed in liquidation as a result of the merger, there may be no freedom of choice on the part of the parties to the amalgamation, in regard to Capitalisation. Indeed, the nature of the capitalisation of each existing Company may be an important factor in the choice of the form which the amalgamation shall assume and of the steps which may be taken to that end.

Capitalisation of new company.

It will be convenient to consider the case where no disadvantages or restrictions are met with owing to past forms of capitalisation. Such a case would occur, for example, where the businesses owned by two private firms were amalgamated by being purchased by a Limited Company specially formed for the purpose, which Company would issue to the owners of the businesses its own Capital.

Choice between one or more classes of capital.

In the first place, there lies the choice between having the whole of the Capital in the form of Ordinary Shares, or of having two classes of Share Capital, namely, Preference Shares and Ordinary Shares.

In support of the policy of having Ordinary Capital only may be mentioned the advantage of simplicity, and also the point that if at some future time it was desired to split this Capital, that is to say, to convert some portion of it into Preference Capital, such a step could be taken without any considerable difficulty—assuming that there was nothing to the contrary in the Memorandum of Association of the Company. So long, of course, as each allottee of the Share Capital in question, that is to say, each owner of the businesses which are being sold, receives Preference and Ordinary Shares in the same ratio and retains such shares, he is, for the time being, in just the same position as if Ordinary Shares only were issued. For example, if two businesses were being bought and the purchase price of each was to be satisfied as to one-third in Preference Shares of the new Company, and as to two-thirds in Ordinary Shares of the new Company, it would make no difference whatever to each Vendor if the new Company subsequently converted its Preference Capital into Ordinary Capital, or, alternatively, if each Company having issued its Capital in the ratio of one Preference Share to two Ordinary Shares, was subsequently to convert one-half of its Ordinary Capital into Preference Capital, so that, in future, its

Capital would be represented as to two-thirds by Preference Shares and as to one-third by Ordinary Shares.

The position has, however, to be looked at in the light of the probability that at some particular time a vendor may require, or may wish, to dispose of a part of his holding; and, from this point of view, the existence of two classes of Capital may be of considerable advantage.

Possible advantages of having more than one class of capital.

Preference Share Capital may take many forms. It may be entitled merely to a fixed rate of dividend in priority to the Ordinary Capital, and such fixed dividend may either be cumulative or non-cumulative. Or again, the Preference Capital may, in addition to the rate of fixed dividend, be entitled to participate further in the surplus profits of the Company, and such participation may cease when a certain point is reached, or, alternatively, it may be unlimited. Again, Preference Share Capital may carry, under all circumstances, votes at Ordinary and Special Meetings of the Company; or, alternatively, the Preference Shares may only carry voting rights if and when the fixed dividend is in arrear.

Speaking, however, of the great majority of cases, the holders of Preference Shares are better secured as to capital than are the holders of Ordinary Shares; their income, though limited, is better secured than the dividend on Ordinary Shares; but, unless the fixed dividend is in arrear, Preference Shareholders would not have the voting control of the Company, and even in the event of the dividend being in arrear the voting control might well remain in the hands of the Ordinary Shareholders.

From the foregoing remarks it will be appreciated that, from the point of view of a large holder in the shares of the Company (such as a vendor of a business would represent), an arrangement whereby a considerable portion of the purchase price is payable in Preference Shares instead of the whole being paid in Ordinary Shares has considerable advantages. It may be that the owner of the

shares may wish to dispose of part of his holding for cash, in order that he may not, in the future, have too many eggs in one basket. At the same time, he may not desire that the control over, or position of importance in connection with, the Company to which his large holding entitles him, should be impaired, or that he should continue to receive in the future a smaller proportion of the profits available for distribution as dividend to the Ordinary Shareholders. In such an event, he could sell the whole, or a large proportion, of his holding in Preference Shares, still retaining all the Ordinary Shares which had been allotted him.

Or, again, he may wish to place certain shares in trust for the benefit of his family or other relations, and, for such a purpose, Preference Shares are clearly more suitable than Ordinary Shares in view of their presumed greater stability and better security from both a Capital and an Income point of view.

It might be mentioned here that under the Companies Act 1929 a Company is at liberty to issue redeemable Preference Shares.

Possible objection to having two or more classes of capital.

One objection which is not infrequently raised against the practice of letting a considerable portion of the initial Capital of the Company consist of Preference Shares carrying a fixed (and therefore a comparatively low) rate of dividend is that if the Company's business continues in future to prosper, a higher rate of dividend (expressed in the form of a percentage) would presumably be paid on the Ordinary Share Capital than would be the case were the whole of the Capital to consist of Ordinary Shares.

If, for example, the total Share Capital of a Company, wholly represented by Ordinary Shares, were £100,000 and the profits available for dividend were £10,000, and such profits were, in fact, distributed, the dividend would be at the rate of 10 per cent, a not unusual rate in the case

of an industrial enterprise which is reasonably successful. If, however, one half of the Capital were to take the form of 6 per cent Preference Shares and the other half of Ordinary Shares, the distributable profits of £10,000 would be applied as follows :

6% on £50,000 Preference Share Capital . .	£3,000
Balance available for dividend on £50,000 Ordinary Share Capital	7,000
	£10,000

This £7000 would represent a dividend on the Ordinary Shares of 14 per cent. In the case of a Company employing numerous workmen, it might be impolitic to arrange the capitalisation on a basis which would lead to so high a dividend as 14 per cent being paid on the Ordinary Share Capital, as the workpeople might use this as an argument in favour of advances in rates of wages. The Company, it is true, would be able to point out that, taking the whole of the Capital together, the rate of profit only represented 10 per cent. It is doubtful, however, whether workpeople appreciate points of this character; knowing little of such matters as capitalisation, or, indeed, of finance generally, they are apt to seize on a point such as the rate of dividend on Ordinary Share Capital and to assume that this constitutes conclusive evidence that the Company is over-prosperous.

Advantages and disadvantages of Debenture Capital.

Another point to be considered is whether the initial Capital of the Company shall, or shall not, include Debenture Capital. The answer to this question depends entirely on the circumstances of the case. Speaking very broadly, if the business in question is of a somewhat speculative nature, or if it is one which is particularly subject to cycles of prosperity and adversity, or if it is one in which the Capital represented by fixed assets, such as Land, Buildings, etc., is relatively small, it will probably be found preferable to arrange for the whole of the initial

Capital to consist of shares, *i.e.* Preference and Ordinary, or Ordinary solely, and not to make an initial issue of Debentures. An advantage of a Debenture Issue from the point of view of the shareholders is that the Debenture-holders have no voting rights and no power of interfering with the business so long as their interest is being punctually paid and their security is not in jeopardy. Also, if the alternatives are being considered of making an issue of Debentures or an issue of Preference Shares, it must be borne in mind that Debenture-holders, having regard to their better security from a Capital point of view, and to the fact that their interest can be paid out of capital, and also to the fact that under certain circumstances they are entitled to have their security redeemed, would be content with a lower rate of income than would Preference Shareholders.

To enable, however, the money to be raised on long term Debentures at a comparatively low rate of interest, it is important, and may be essential, that fixed assets should exist of sufficient value to afford a good security for the debentures, and that these assets should be specifically charged in favour of the Debenture-holders. It is also very advisable that the earnings of the business should not fluctuate very widely as between one year and another, or as between one series of years and another, as in the event of a Company being unable to pay Debenture Interest, the Debenture-holders might foreclose and appoint a Receiver, thus taking the control of the Company's business out of the hands of the Shareholders. Further, the existence of a Debenture Debt makes it more difficult for the Company to borrow on favourable terms further money if and when required for the purpose of its business, either to make good the Floating Capital which has disappeared as the result of trading losses, or to provide additional Capital for the needs of an expanding business.

Again, a Company whose success is, to a considerable degree, dependent upon its credit may be prejudiced in the eyes of those with whom it engages in business, and its activities consequently restricted, by reason of its having a Debenture Issue.

Debentures may either be irredeemable (except in the event of a liquidation or the appointment of a Receiver), or they may be redeemable over a certain period or at the end of a certain period. Of late years, the practice has been growing of making Debenture Issues redeemable, and certainly this practice has much to recommend it from the point of view of prudent finance, as the Company in question usually sets aside from its profits year by year a sum calculated to redeem the debentures in a manner provided for in the Debenture Trust Deed, and by this means the financial position becomes yearly more sound. At the same time, a Company which owns a business which has shown material expansion in the past and is expected to continue this rate of progress in the future may be ill-advised to create a Debenture Debt which is redeemable by a sinking fund out of profits, as the Company will presumably need additional Capital to finance the expansion of its business, and unless this Capital can be found by retaining in the business considerable sums out of the annual profits which remain after meeting the Interest and Sinking Fund on the Debentures, the only alternative is for the Company to issue fresh Capital which, presumably, must rank behind the existing Debenture Issue and which must therefore carry a higher rate of interest or dividend. It is clearly bad finance that a Company should be simultaneously occupied in paying off Capital carrying a low rate of interest and raising fresh Capital on which a higher rate required to be paid.

On the other hand, a debenture debt redeemable by a Sinking Fund out of profits is particularly appropriate in

the case of Companies having wasting assets. In arriving at the true profits of such Companies, depreciation of the wasting assets usually requires to be charged (for reasons of financial prudence, though legally there may be no such obligation), and the effect of writing off this depreciation is that cash accumulates in the business, assuming that such cash is not required to meet Capital Expenditure. If there is an issue of debentures to which a Sinking Fund is attached, such cash could conveniently be used to repay the debentures which require so to be dealt with each year under the provisions relating to the Sinking Fund.

As already stated, it is permissible (under the Companies Act 1929) to issue redeemable Preference Shares. Such shares can therefore be gradually redeemed by a Sinking Fund in the same manner as debentures.

Another point in favour of a Debenture Issue is that a Company can, when it has the surplus funds to spare, and thinks it advisable to do so, purchase some of its own debentures on the market, and may continue to hold them, or it may dispose of them again if it subsequently finds it is in need of the cash. A Company is, however, precluded from purchasing its own shares.

Proportions which the various classes of capital may bear to each other.

The proportions which Debenture, Preference and Ordinary Capital respectively may or should represent of the total Capital of a Company depend entirely upon circumstances. The smaller the proportion of the Debenture and Preference Capital to the Capital as a whole, the better, of course, the security for such prior Capital and the lower the rate of interest or dividend which need be paid thereon. Similarly the larger the proportion of the Debenture and Preference Capital to the Capital as a whole, the higher the percentage rate of dividend which should be payable on the Ordinary Capital, and the more speculative the character of such latter Capital. It is very unusual to issue any Debenture or Preference

Capital in respect of Goodwill. Goodwill is usually the most speculative of the assets of a Company, and any value there may be in Goodwill is usually included in the value of the Ordinary Share Capital. Capital issued in respect of Goodwill.

Reference was made in Chapter X. to Mr. Leake's comments on the character of the Goodwill of an industrial undertaking, that is to say, that such Goodwill represented a wasting asset. In pursuance of this line of thought Mr. Leake suggests that it would be most appropriate that any Capital issued by a Company in respect of the acquisition of commercial Goodwill should be of a temporary and not of a permanent character, such, for example, as Debenture Capital redeemable over a fixed period by means of a Sinking Fund accumulated out of profits. Mr. Leake appreciated, of course, the fact that Debenture Stock (of the class or character usually created) is, practically speaking, never issued as consideration for Goodwill or ear-marked as being in respect of Goodwill, as it is necessary that such Stock should have, as security, assets of a more tangible character. Mr. Leake suggests, however, that some form of deferred Debentures might be devised, and that such security should not carry a fixed rate of interest, but that the income paid thereon in respect of each year should depend upon the current profits. He argues that if the profits are less than sufficient to pay a normal rate of income on the Capital invested apart from Goodwill, there can be no dividend properly available for the deferred debentures or other form of security which has been issued against the cost of the purchased Goodwill.

As has, however, already been stated, it is the usual and almost invariable practice to issue Ordinary Share Capital in respect of Goodwill.

It is important, in arranging the details of Capitalisation, to have regard not only to the immediate, but also Need for elasticity in capitalisation.

to the more distant, future. In other words, the capitalisation should be so arranged as to allow for expansion. If, for example, a Company is created with an Authorised Capital of £200,000, of which £50,000 is Preference Capital and £150,000 is Ordinary Capital, and if there has been issued the whole of the Preference Capital, *i.e.* £50,000, and of the Ordinary Capital £50,000 (leaving unissued Ordinary Capital of £100,000), the only form in which the Company can issue additional Share Capital (without taking the steps necessary to increase the Authorised Capital) is in the form of Ordinary Shares. Such an issue would very much improve the security for the existing Preference Capital, and no *quid pro quo* would be received from the Preference Shareholders in respect of this benefit. It is suggested that it would have been preferable that the Company should have been formed with an Authorised Capital of £100,000 in Preference Shares, and £100,000 in Ordinary Shares. If £50,000 of each class of Capital had been issued, there would then remain unissued £50,000 of Preference Capital and £50,000 of Ordinary Capital. The Memorandum and Articles would provide, for the protection of the Preference Shareholders, that the unissued Preference Share Capital could only be issued on the basis that at no time should the total issued Preference Share Capital exceed the total issued Ordinary Capital. This would give the Company wider latitude in regard to the future issue of Capital, and it would at the same time afford a reasonable protection to the existing Preference Shareholders.

Considerations in arranging rates on securities carrying a fixed income.

A point to be borne in mind in fixing the rate of interest on Debenture Capital and the rate, or scale, of dividend on Preference Share Capital is that the rate should, broadly, be such as will enable further Capital, ranking *pari passu* with such existing Capital, to be issued for cash should such a course subsequently be desirable. If, for example, too low a rate of interest be fixed in

respect of the Debenture Capital, then if it is decided at some future time to issue further Debenture Capital ranking *pari passu* with the existing issue (assuming the Company is entitled to take such a step), such further Debenture Capital might only be able to be raised at a considerable discount. This discount has to be written off out of profits over the period of the Debenture Issue, and although its existence may be compensated for by the low rate of interest being paid on the Debentures, it is suggested that, in normal circumstances, it is preferable, both from the point of view of appearances and otherwise, that Debenture Capital should be issued at, or near, par. As regards Preference Share Capital, the point is of greater importance, as future issues of such Capital ranking *pari passu* with existing issues cannot be made at a discount, except by the indirect method of paying a commission in consideration of their being taken up at or over par. It is therefore important to attach such a rate, or scale, of dividend to Preference Capital as should justify it in commanding par or something over par on the market.

As between the parties, a generous or a conservative capitalisation is immaterial.

It will be appreciated, in regard to the question of Capitalisation generally, that where the whole of the consideration for the sale of various businesses which are to be amalgamated is to take the form of shares (or, alternatively, of shares and debentures), it does not matter, *as between the interested parties*, whether the value of each business is arrived at on a generous basis or on a conservative basis. Each party is only interested in seeing that of the Capital which the new Company is to issue he receives that proportion to which the relative value of his business, as compared with the values of the businesses as a whole, entitles him.

For example, two businesses, " A " and " B ", may be valued for amalgamation purposes at £100,000 and

£200,000 respectively, such values being arrived at on a prudent, but not an ultra-conservative, basis.

It may be decided that a new Company is to be formed to purchase the businesses, and that the purchase price of each business shall be satisfied as to one-quarter in the Debentures of the new Company; as to one-quarter in Preference Shares of that Company; and as to the remaining one-half in Ordinary Shares in that Company. If the valuations of the businesses are adhered to, the new Company might issue to the owners of "A":

£25,000 in Debentures,
£25,000 in Preference Shares, and
£50,000 in Ordinary Shares;

and it would issue to the owners of business "B":

£50,000 in Debentures,
£50,000 in Preference Shares, and
£100,000 in Ordinary Shares.

Theoretically, the above Capital, taken as a whole, should be worth its par value, and it will be presumed that the rates of interest and dividend attached to the Debentures and Preference Shares respectively are such as should warrant each issue being worth par; in such a case the Ordinary Shares also would clearly be worth par. The owners of the business may, however, desire, for reasons which seem good to them, to increase, or, alternatively, to lower the capitalisation of the new Company. To whatever extent the capitalisation is raised or lowered, the parties, as between themselves, are not affected at all, as the owner of business "A" would still receive one-third of the whole of the Issued Capital of the new Company, and the owner of business "B" two-thirds of such issued Capital. In other words, the two owners would be entitled respectively to a one-third and a two-thirds share in the net assets of the two busi-

nesses combined, and the total nominal value of the Debenture and Share Certificates which they each received as evidence of their interest in the business would be immaterial.

Choice between high and low capitalisation.

Although, however, the relative interests of the two owners are not disturbed in any way, it may be to their mutual advantage that the Capitalisation should be increased, or, alternatively, that it should be reduced.

Possible benefits of a generous capitalisation.

If, for example, the owners have every reason to believe that the businesses will exhibit increasing prosperity, the real value of the Ordinary Share Capital in the course of a few years (when all the advantages of the amalgamation will have been secured) may well be considerably in excess of its nominal value. If at any future time, therefore, the owners wished to dispose of some of their Ordinary Shares, they might not be able to sell them so favourably as would be the case if the capitalisation, at the time of the merger, had been arranged on a more generous scale, and, consequently, the Issued Ordinary Share Capital had appeared at a larger amount. Buyers of shares not infrequently look askance at a high premium, although the premium may be well justified by the assets and earnings of the Company in question. For example, let it be assumed that one Company has an Ordinary Share Capital of £100,000 in shares of £1 each, and that such shares, when measured by the intrinsic value of the assets, are worth £2 each. And let it be assumed that another Company has a Share Capital of £200,000 in shares of £1 each, and that, measured by the intrinsic value of the assets, these shares are worth their par value, *i.e.* £1. It would be found easier—all other circumstances being equal—to find a buyer for the shares of the last-mentioned Company at £1 than for those of the first-mentioned Company at £2.

There is this further objection to capitalising on too conservative a basis, namely, that an investor in

Debentures or Preference Shares might be a little apt to look at the *nominal* amount of the Issued Share Capital ranking behind his security and not to pay adequate attention to the question of the *real* value of such Capital. If, therefore, a Company were capitalised on an extremely conservative basis, and, as a result, the issued Share Capital were fixed at a figure much below its real value, a casual inspection of the Balance Sheet might lead a person to believe that the finance was "top-heavy", *i.e.* that an undue proportion of the total Capital was represented by debentures and preference shares.

A further objection to the ultra-conservative method of capitalisation is that the percentage rate of the dividend payable in future on the Ordinary Capital might be correspondingly high, and this, as already stated, may be inadvisable from the point of view of its effect on the attitude of workpeople.

Another point which should be borne in mind is that if a low capitalisation is decided upon, this probably cannot afterwards be corrected by a subsequent writing up of the Capital except by means of a reconstruction involving the trouble and expense of liquidation.

Reasons such as the above might therefore preclude the owners of the two businesses previously referred to from agreeing, as a conservative measure, to reduce the total issued Ordinary Capital from £150,000 (of which the owner of "A" would receive £50,000 and the owner of "B" £100,000) to, say, £75,000, of which the owner of "A" would receive £25,000 and the owner of "B" £50,000.

Possible objections to a generous capitalisation.

On the other hand, there are obvious disadvantages which may attend a too generous capitalisation. If the business in question does not maintain its prosperity, the original Share Capital may become worth considerably less than its par value. Such a state of affairs gives the

Company the appearance of weakness, with possible detriment to its credit and standing. And the weakness does, in fact, exist, as the assets are not, as a whole, worth the total at which they stand in the Balance Sheet ; and this state of affairs can only be redressed by a reduction in Share Capital, or by the application, out of profits, of sums to write down certain of the book figures relating to the assets, in order to reduce them to amounts representing true values.

Further, the fact that the Share Capital is worth less than its nominal value will probably preclude or hinder the Company from issuing further Share Capital ranking *pari passu* with existing Capital, if at any time it required to raise additional resources by this means.

Another objection to a high capitalisation, which applies where such assets as Buildings, Plant and Machinery are brought into the Balance Sheet at over-full values, is that the sums required to be charged annually in respect of depreciation of such assets in arriving at the net profits available for dividend, must be correspondingly high, as such sums must be calculated with a view to writing the assets completely out of the books by the time that their economic values have expired. On the other hand, of course, a saving in Income Tax may be effected by reason of the larger allowance granted by the Inland Revenue Authorities in respect of depreciation.

Capitalisation of existing companies.

The remarks so far made in this chapter concern new Companies, and do not necessarily cover the cases where there are existing Companies which do not require to be liquidated, and where questions of possible alterations in, or additions to, the capitalisation arise. Such variations of capitalisation may take the form of an alteration in the rights attaching to a certain class, or classes, of shares ; or of the writing down of Share Capital in order to write off

past losses, or of the writing up of the Share Capital by capitalising existing free reserves.

It is obvious that in practically every case the circumstances must differ in one or more respects, and that the appropriate treatment may vary correspondingly. It is, however, impossible to enter into any description, or make any comments, which will be of general application. A number of the merits and demerits of various forms of capitalisation (where an entirely fresh Company is being formed) have already been referred to earlier in this chapter; and the remarks made in regard to these will be helpful in considering possible alterations in, or additions to, the Capital of existing Companies, where such a course may be advisable.

Illustrations of various capitalisations.

In order to illustrate a number of the points which have been referred to in this chapter, certain *pro forma* Examples have been set out in Appendix D, and it is recommended that these should be studied.

CHAPTER XIV

SUMMARY OF THE ADVANTAGES AND DISADVANTAGES OF THE ALTERNATIVE FORMS OF AMALGAMATION

FROM the detailed descriptions and comments which have already appeared in this book in regard to the three main forms of merger, namely, a "Complete Amalgamation Scheme" (see Chapter V.), a "Holding Company Scheme" (see Chapter VI.), and a "Pooling Agreement" (see Chapter VII.), the relative advantages and disadvantages of each method will be apparent.

In order, however, to bring these points more clearly and concisely into view, it has been thought convenient to summarise them in this chapter in the form of the following Tabular Statement.

[TABLE

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MATTER TO BE CONSIDERED	RELATIVE POSITION UNDER EACH FORM OF MERGER			Page Reference
	SCHEME OF COMPLETE AMALGAMATION	HOLDING COMPANY SCHEME	POOLING AGREEMENT	
Extent to which benefits anticipated from a merger of interests, as referred to in Chapter II., can be reaped.	This Scheme is preferable to either of the others.	This Scheme is preferable to the Pooling Agreement, but is probably less advantageous than the Scheme of Complete Amalgamation.	This Scheme is the least advantageous of the three methods of merger.	81-84, 100
Expenses in the form of Duties on Authorised Capital of Limited Companies and on conveyance of Assets.	This Scheme is probably the most expensive in this connection. These expenses, in the majority of cases, are, however, very much minimised since the passing of the Finance Act 1927. (See Appendix F.)	This Scheme is probably less expensive than the Scheme of Complete Amalgamation. These expenses, in the majority of cases, are, however, very much minimised since the passing of the Finance Act 1927. (See Appendix F.)	There is no expense under these heads; the Pooling Agreement, therefore, in this respect has the advantage of the other two Schemes.	60, 86

Initial Expenses (apart from Stamp Duties) incidental to the merger, such as Legal Expenses, Valuer's Fees, Accountants' Charges, Printing, Circularising, etc.	This Scheme is probably the most expensive in this connection.	This Scheme is probably less expensive than the Scheme of Complete Amalgamation.	In proportion to the similar expenses under the other two Schemes, the expenses under these heads in the case of a Pooling Agreement would probably be trifling.	30, 86
Trouble, inconvenience (and possibly risk) in connection with the conveyance or transfer of Assets (e.g. *property, stocks and shares, etc.*).	This disadvantage will probably be most felt in the Scheme of Complete Amalgamation.	The Holding Company Scheme has, under this head, important advantages over the Scheme of Complete Amalgamation.	No such circumstances arise under a Pooling Agreement. This method of merger has, therefore, in this particular respect, the advantage of either of the other two methods.	86
Inconvenience, difficulties, delays and expenses, owing to the liquidation of one or more Companies.	Any disadvantages under these heads are peculiar to the Scheme of Complete Amalgamation.	These disadvantages are not met with in a Holding Company Scheme.	These disadvantages are not met with under Pooling Agreement.	86
Difficulties in connection with protection of outside Shareholders.	These do not arise under the Scheme of Complete Amalgamation.	These difficulties do, or may, arise in the case of the Holding Company Scheme.	These difficulties do not arise under a Pooling Agreement.	72, 73

MATTER TO BE CONSIDERED	RELATIVE POSITION UNDER EACH FORM OF MERGER			Page Reference
	SCHEME OF COMPLETE AMALGAMATION	HOLDING COMPANY SCHEME	POOLING AGREEMENT	
Expenses, difficulties or inconvenience arising annually in the future—incidental to the Amalgamation Scheme.	These are reduced to a minimum, or are non-existent, under a Scheme of Complete Amalgamation.	While these may be greater than under a Scheme of Complete Amalgamation, they are not, in ordinary cases, of any great importance.	These disadvantages are much more likely to be experienced under a Pooling Agreement than under either of the alternative forms of merger.	84, 100
Possible disadvantages owing to publicity (or advantages owing to secrecy).	From this point of view, the Scheme of Complete Amalgamation is the least favourable of the three.	This Scheme is less favourable in this particular respect than the Pooling Agreement, but is probably more favourable than the Scheme of Complete Amalgamation.	In this respect the Pooling Agreement certainly has advantages over either of the other two methods of merger.	63, 86
Ease or convenience with which new parties to the merger can be admitted at some subsequent time.	In this respect the Scheme of Complete Amalgamation probably has some advantages over a Holding Company Scheme, and it certainly has advantages over the Pooling Agreement.	The Holding Company Scheme is, in this respect, more advantageous than the Pooling Agreement, but probably less advantageous than the Scheme of Complete Amalgamation.	Under this head the Pooling Agreement is the least favourable of the three forms of merger.	101

Permanence of merger. Advantages.	If permanence is an advantage, the Scheme of Complete Amalgamation cannot be bettered.	Under ordinary circumstances, the Holding Company Scheme is just as beneficial, from the point of view of permanence, as the Scheme of Complete Amalgamation.	If permanence is an advantage, the Pooling Agreement, being for a limited period only, is the least preferable of the three Schemes.	100
Temporary character of merger. Advantages.	If it be of advantage to the parties that the merger should be temporary, *i.e.* that the *status quo* should at some future time be resumed, if desired, a Scheme of Complete Amalgamation, being permanent, is open to objection.	Broadly speaking, the same remarks apply here as in the case of the Scheme of Complete Amalgamation, but not, perhaps, with quite the same force.	If it be of advantage to the parties that the merger should be temporary, *i.e.* that the *status quo* should at some time be resumed, if desired, the Pooling Agreement, being for a limited period only, has obvious advantages over either of the other alternative methods.	87
Advantages of preserving Debenture and Preference Share Capital carrying low fixed rates of interest and dividend.	In some cases this advantage would be lost under a Scheme of Complete Amalgamation.	Under a Holding Company Scheme this advantage is always preserved.	Under a Pooling Agreement this advantage is always preserved.	29, 66

MATTER TO BE CONSIDERED	RELATIVE POSITION UNDER EACH FORM OF MERGER			Page Reference
	SCHEME OF COMPLETE AMALGAMATION	HOLDING COMPANY SCHEME	POOLING AGREEMENT	
Possibility of altering the form of the merger at some future date.	In this respect the Scheme of Complete Amalgamation is the least preferable of the three, as it closes the door to alteration in the form of the merger.	In this respect a Holding Company Scheme is preferable to the Scheme of Complete Amalgamation, in that at some subsequent date a Scheme of Complete Amalgamation can be effected if desired.	In this respect the Pooling Agreement has advantage over either of the other Schemes, as it is no bar to a Holding Company Scheme being effective later or a Scheme of Complete Amalgamation.	84, 87
Improved facilities for disposing of owner's interest in a business, either during his lifetime or at his death.	The Scheme of Complete Amalgamation is probably the most advantageous in this respect.	The Holding Company Scheme cannot be more advantageous than the Scheme of Complete Amalgamation, and may be less so.	Under the Pooling Agreement no benefits under this head can be obtained.	16

CHAPTER XV

CONCLUDING OBSERVATIONS ON AMALGAMATIONS

AT the risk of being adjudged guilty of repetition, the author thinks it well to conclude this work by making the following few observations of a general character.

Persons who own Industrial businesses, or who are in a position to influence the destinies of such businesses, may conceivably take one of two extreme views in regard to Amalgamations.

Some persons may be inclined to think that Amalgamations constitute an effective cure for most of the ills or weaknesses to which an Industrial business may be subject. People holding such views are liable to form a rash alliance between their businesses and those of others, and to realise too late that the expectations which they entertained as to the results of the merger were unjustified.

Speaking of the great majority of cases, a merger is of little advantage unless one of the businesses at least enjoys a position of some strength—*i.e.* in regard to finance and management—or, at any rate, has within it some of the elements which, given reasonable opportunities, make for success. The mere joining together of two or more weak entities does not, of itself, remove the weakness; in fact, it may even accentuate it. Two inebriated men, when walking in company, are more likely to fall than to prop each other up. A strong business joined to a weak one may, and probably will, bring the weak business in time to a position of strength by placing at the disposal of the latter its experience and organisation.

It may be suggested that a possible exception to the above general rule would be found in the case of two businesses which, though well managed, might have been brought to a precarious position by excessive competition with each other, but which, as a result of amalgamation, again become strong. But even in such a case the germ from which success ultimately springs—*i.e.* the good management, or, in other words, the brain power—has been present throughout but has been stultified by extraneous circumstances.

While some persons may be too favourably inclined to Amalgamations in principle, diametrically opposite views may be held by others.

Not a few men are to be found, owning or exercising the management control over businesses, who think that their own business can have nothing whatever to gain under any circumstances from an alliance with another business. It may well be the case that, taking all considerations together, an amalgamation would not be in the best interests of the business; but this is very different from saying that in no respect whatever could the business gain any advantage from a merger. There is a certain type of man—by no means uncommon—who has built up a successful business by his own energy and initiative; who holds very distinct ideas as to the lines on which the business is to be run and as to what is good policy and what is bad policy; who is accustomed to impose his will upon others, and who is not inclined to give a fair hearing to those who advocate other methods. Such a man is apt to forget that while none of his competitors may be quite as well equipped in enterprise and ability as himself, yet in some respects he may have much to learn from them. In other words, he under-estimates the advantages derivable from a pooling of experience and brain power.

It must be remembered that when an amalgamation has been effected all parties become interested in the business as a whole. Any improvements in organisation or management resulting from a merger—no matter whether they arise from Mr. X utilising his brains and experience for the benefit of the business previously owned by Mr. Y, or whether they arise from Mr. Y utilising his powers for the benefit of the business previously owned by Mr. X—therefore benefit both the parties. If Mr. X considers himself (in his heart of hearts) as the most efficient man, and, consequently, believes that he is benefiting, by his knowledge, Mr. Y's business more than Mr. Y is benefiting his (Mr. X's) business, he can console himself with the reflection that of the improved results of Mr. Y's business he (Mr. X) enjoys a share.

The above references to dominating personalities serve to introduce the third general observation in this chapter, namely, that persons who contemplate merging their businesses with those of others must be prepared in conducting the negotiations to adopt and exhibit a spirit of compromise, and must not expect that their own ideas as to what is right and proper must necessarily prevail; and, further, it may be necessary for them to put themselves to some considerable extent in the hands of others (*e.g.* professional Valuers and professional Accountants) in regard to the determination of the values of their businesses relative to those of the other business to be merged. Furthermore, assuming that the amalgamation is effected, these strong-willed parties must be prepared, when in harness with a number of others, to show consideration for the views of their associates, and to exhibit tact and patience in proposing and carrying into execution any reforms which are considered to be necessary.

While speaking of strong—and uncompromising—

men sometimes causing difficulties in connection with amalgamation schemes, it may be appropriate to mention that objections to amalgamations not infrequently emanate from weak men. It occasionally happens that persons who have a voice in the decision as to whether a business shall or shall not amalgamate with others hold administrative positions in that business, which they are filling not too effectively; in other words, they are " not pulling their weight ". Such men naturally fear that as a result of the amalgamation their weaknesses will be exposed and their positions therefore prejudiced. They therefore hesitate to approve a proposed amalgamation.

Another class of objector is represented by Boards of Companies whose businesses have been suffering year by year substantial losses, with the result that the bulk of the real value of the Shareholders' Capital has disappeared. In such a case an amalgamation must involve a very drastic writing down of the nominal value of Share Capital; and in some circumstances the Directors shrink from telling the Shareholders that such a large proportion of the latter's Capital has been irretrievably lost. They are apt to put off the evil day and to live in hope that " something will turn up ", instead of facing the situation, however unpleasant this may be.

The last observation is one touching the subject-matter dealt with in this book.

While the chief classes of amalgamation can be grouped under three heads, it will be appreciated that, in practice, no one amalgamation is, in form, exactly like another. In every instance one or more special circumstance will be present which will demand special treatment. Similarly, in regard to the steps to be taken to consummate a merger when once the form of the merger has been decided, special considerations may arise, and special arrangements or methods may conse-

quently be required in order to deal with the situation on appropriate lines.

Bearing the above facts in mind, it is necessary that the reader should realise that the statements made and the opinions expressed in this book must be regarded as incidental to a description of the general principles affecting amalgamations, and not in the light of rules or dicta which are unalterable. And, furthermore, it is necessary that he should bear in mind that, in respect of each of a number of matters incidental to amalgamations—such, for example, as the capitalisation of Limited Companies, the valuation of Fixed Assets, the valuation of Goodwill, legal considerations arising—whole volumes could be written by those who are specialists in these respective spheres. Matters such as these have been dealt with in broad outline or touched upon quite briefly, partly by reason of consideration of space, and partly because the author, being an Accountant and not a Surveyor or a Solicitor or a financial expert, cannot claim to possess specialised knowledge in any of the directions indicated, but merely a working acquaintanceship.

CHAPTER XVI

GENERAL REMARKS ON THE VALUATIONS OF BUSINESSES OTHER THAN FOR AMALGAMATION PURPOSES

As was indicated in the Preface to this book, the general considerations which apply in the case of the valuation of a business for amalgamation purposes obtain also in regard to a valuation of that business for other purposes. It therefore follows that nearly the whole of the information given in Chapters VIII., IX., X., XI., and XII., as relating to valuations for amalgamation purposes, is equally applicable where the object for which the valuation is being made is a different one altogether.

Examples of the purposes for which such valuations require to be made are:

(*a*) When a business changes hands in the ordinary way.

(*b*) When a business owned by a private individual or by a firm is put under the ownership of a Limited Company.

(*c*) Where a Limited Company, by reconstruction or otherwise, reconstitutes its Balance Sheet, in order that the capitalisation shown by the latter may give a truer indication of the financial position of the business or undertaking in question.

(*d*) When the owner of a business dies and that business has to be valued for probate purposes. Also when a shareholder in a Limited Company which owns a business dies and there is no market quotation for the shares (or where the

market in the shares is so limited that the quotation cannot be taken as a fair guide to the real value).

Where businesses are being valued for amalgamation purposes it must be remembered that in the great majority of cases such valuation represents, in the case of each business, the price at which the owner as an individual sells to a group of which he is a member. The vendor is therefore a willing seller, and the purchaser a willing buyer; and it is on the basis of a transaction between a willing buyer and a willing seller that the valuation is made, the assumption being that the degree of "willingness" on both sides is equal. And, further, as the vendor, by reason of forming one of a body of purchasers, is also interested in the future success of the business, the sale is usually accompanied by a stipulation, or at least an understanding, that in all matters connected with the sale the vendor shall, so far as he is able, do all in his power to facilitate matters in the interests of the business as a continuing entity.

All the above considerations naturally have some bearing upon the question of what constitutes the fair value of each business which is to be acquired by the "combine".

But in the cases of valuations for other purposes, such as those referred to under (*a*), (*b*), (*c*) and (*d*) above, other considerations may be involved, which may have a material bearing upon the question of what is a fair value to put upon a business.

For example, under case (*a*)—namely, when a business changes hands in the ordinary way—the value as between a willing buyer and a willing seller may be very different from the value which the owner of the business might be able to obtain on a sale. The owner may be a willing seller, indeed he may be very anxious to sell, but

unless he can find some one who is equally anxious to buy, he may have to accept a somewhat lower price than the "fair value as between a willing buyer and a willing seller". And conversely the owner may not be at all anxious to sell, but one or more of the prospective purchasers, from one cause or another, may be very anxious to buy; and in such a case the vendor may well obtain a price materially in excess of the "fair value as between a willing buyer and a willing seller".

Furthermore, where the owner of a business has taken an active part in the management, the value of that business, on a sale, may well depend to no little extent on whether the vendor will agree to devote, in consideration of a remuneration, any of his time to the direction of the affairs of that business in the future. And the same principle applies in the case of managers and other men in responsible positions on the staff of a business: in other words, whether, as a result of the change of ownership, they are likely to relinquish their posts.

As regards a valuation under (*b*)—namely, where a privately owned business is put under the ownership of a Limited Company—the basis of the valuation as between a willing buyer and a willing seller can safely be followed. In view, however, of the fact that the ownership of the business does not really change hands, there is no object to be gained in ensuring that the value, while a fair one, should be a full one. Indeed it is usual, in such cases, to adopt, as a measure of prudence, a basis of value somewhat on the low side, in order that the initial Balance Sheet of the new Company may be drawn up on conservative lines.

A similar conservative basis of valuation would usually be followed in cases under (*c*)—namely, where a Company is recapitalised. Such cases most frequently occur where a Company's assets have depreciated very considerably in value, or where they have been depleted

by trading losses. The assets which exist at the date of recapitalisation are then valued on a conservative basis according to the best information available at that time, the liabilities are deducted from the total of assets so computed, and the share capital is fixed at an amount equal to the sum thus arrived at.

With respect to cases falling under class (*d*)—namely, valuations for probate purposes—the circumstances are, or may be, somewhat different. The Inland Revenue Authorities require that in such cases the valuation shall be made on the basis of a sale by a willing seller to a willing buyer. Unlike cases (*b*) and (*c*), however, there is here a change of ownership, and it is not infrequently found that the death of the owner has a prejudicial effect on the future of the business—*i.e.* where the owner, by reason of his services to the business, or by reason of his influence, has contributed to the prosperity of the undertaking. Circumstances like these are allowed to be taken into account in the valuation. Again, it occasionally happens that the business is of such a character, or the conditions relating to it are such, that the persons who might conceivably wish to make an offer for it (assuming that it were put on the market for sale) are very few in number. A buyer in such circumstances might quite well be a " willing buyer " ; but the price he would be willing to offer might conceivably be materially lower than would be the case if he knew that there were a considerable number of other possible purchasers.

The above general observations are intended to emphasise the fact that it is one thing to make a valuation of a business on the basis of a sale by a willing seller to a willing buyer, but it is, or may be, another thing to suggest that such valuation, when made, is fair for all purposes. To put it briefly, " a business is worth what it will fetch " ; and what a business will fetch depends upon the circumstances surrounding the actual or assumed sale.

APPENDIX A

FIVE EXAMPLES ILLUSTRATING THE CIRCUMSTANCES WHICH INFLUENCE THE CHOICE AS TO THE FORM WHICH A MERGER SHALL TAKE

FIVE EXAMPLES ILLUSTRATING THE CIRCUMSTANCES WHICH INFLUENCE THE CHOICE AS TO THE FORM WHICH A MERGER SHALL TAKE

EXAMPLE I

THE following is a Summary of the affairs of two companies which own businesses of a similar character and which desire to merge their interests.

COMPANY "A"

BALANCE SHEET

Share Capital authorised and issued— 100,000 Ordinary Shares of £1 each	£100,000	Fixed Assets	£80,000
Trade Liabilities	23,000	Floating Assets	45,000
Balance on Profit and Loss Account	2,000		
	£125,000		£125,000

The net profits do not show much variation as between one year and another, and average £15,000 per annum.

COMPANY "B"

BALANCE SHEET

Share Capital authorised and issued—			Fixed Assets	£80,000
50,000 Ordinary Shares at £1 each	£50,000		Floating Assets	45,000
30,000 5% Preference Shares of £1 each	30,000			
		£80,000		
4% Debenture Capital (not redeemable at or by any fixed date)		20,000		
Trade Liabilities		23,000		
Balance on Profit and Loss Account		2,000		
		£125,000		£125.000

The profits remained at about the same figure for a number of years, and averaged about £15,000 a year before charging Debenture Interest.

If a merger of the interests of the above two Companies is desired, it can probably best be effected by Company "A" buying from the individual ordinary shareholders of Company "B" their holdings and issuing its own Ordinary Shares as consideration therefor. This would involve Company "A" increasing the amount of its Authorised Share Capital, but such a step could be taken without difficulty.

The merger would involve the valuation of the existing Ordinary Shares of Company "A" and a similar valuation of the Ordinary Shares of Company "B". From the profits earned by the two Companies it is apparent that in each case the Ordinary Share Capital is worth a figure in excess of its par value.

The fair value of the existing Ordinary Shares in Company "A" may, perhaps, be taken to be 27s. 6d. per £1 share, and the fair value of the Ordinary Shares in Company "B" may possibly be considered as being 32s. per £1 share. On the above basis, the number of new Ordinary Shares which Company "A" would require to issue to the individual Ordinary Shareholders of Company "B" in exchange for their holdings of the nominal value of £50,000, would be £58,182, arrived at as follows:

Value of 50,000 Ordinary Shares of £1 each in Company "B" at 32s. a share—£80,000.

The number of Ordinary Shares of £1 each in Company "A" required to be issued as payment for an asset which is worth £80,000 is (on the basis of the value of an Ordinary Share in Company "A" being worth 27s. 6d.) £58,182.

The Balance Sheet of Company "A", after the transaction had been carried through, and assuming that the whole of the Ordinary Shareholders in Company "B" effected the exchange, would appear as follows :

BALANCE SHEET

Ordinary Share Capital, in Shares of £1 each, authorised and issued—			Fixed Assets (as before) . .	£80,000
Original Issue . .	£100,000		Floating Assets (as before) .	45,000
Issued in payment for 50,000 Ordinary Shares of £1 each in Company "B" . . .	58,182		Cost of 50,000 Ordinary Shares of £1 each in Company "B" at 32s. a share . . .	80,000
		£158,182		
Premium on last-mentioned Issue		21,818		
Trade Liabilities (as before) .		23,000		
Balance on Profit and Loss Account (as before) . .		2,000		
		£205,000		£205,000

As Company "B" continues its existence as before, no change in its Accounts takes place. The personnel of the Shareholders will have changed, but this has no effect on the constitution or capitalisation of the Company.

By a merging of interests on the above lines, the Debenture and Preference Capital raised by Company "B", at what are at the present time low rates of interest and dividend respectively, remains unaffected; and this means that the Ordinary Shareholders of Company "B" (namely, Company "A") retain the benefit which this raising of prior Capital at cheap rates confers.

Objections to other alternative forms of merger may be briefly noted.

If Company "A" were to buy the *business* of Company "B", and the latter Company were, in consequence, wound up, the Debenture Holders and Preference Shareholders in Company "B" would have

the right to be paid off at par, or, in other words, at prices much in excess of what the current value of their securities would be on the basis of Company " B " continuing to carry on business. In effect, therefore, a present would be made to the Debenture Holders and Preference Shareholders of Company " B ", and this present would really come out of the pockets of the Ordinary Shareholders of Company " B ". The point may be expressed in another way by saying that the Ordinary Shareholders of Company " B " would obtain a better price for their shares if these were sold to third parties and Company " B " were to continue to carry on its business, than would be the case were the business of Company " B ", as such, sold and the proceeds devoted, firstly, to repaying the Debentures and the other liabilities of Company " B "; secondly, to repaying the Preference Shareholders; and thirdly, to repaying to the Ordinary Shareholders the balance then remaining.

Another alternative form of merger is that Company " B " should enlarge its Issued Ordinary Share Capital and acquire the business of Company " A ", issuing such additional Ordinary Share Capital as consideration therefor. The Shareholders in Company " A " might not, however, like to exchange their holdings for holdings of Ordinary Share Capital in a Company having a Debenture and a Preference Share Issue ranking in front of its Ordinary Share Capital. And further, from the point of view of the combined undertaking, the existence of Debenture Capital might have some effect on the Company's ability to raise money on Loan Account from bankers or others, should such a course at any time be desirable. Under the Scheme suggested as the appropriate one, the Assets of Company " A " would remain uncharged in respect of any Loan Capital, and to that extent the Company would be favourably situated in regard to future borrowings, if such were desired.

EXAMPLE II

The following is a Summary of the affairs of two Companies which own businesses of a similar character and which desire to merge their interests.

COMPANY "C"

BALANCE SHEET

Share Capital, authorised and issued— 100,000 Ordinary Shares of £1 each	£100,000	Fixed Assets	£80,000
Trade Liabilities	23,000	Floating Assets	45,000
Balance on Profit and Loss Account	2,000		
	£125,000		£125,000

The net profits do not show much variation as between one year and another, and average £5000 per annum.

COMPANY "D"

BALANCE SHEET

Share Capital authorised and issued—			Fixed Assets	£80,000
50,000 Ordinary Shares of £1 each	£50,000		Floating Assets	45,000
30,000 5% Preference Shares of £1 each	30,000			
		£80,000		
4% Debenture Capital (not redeemable at or by any fixed date)		20,000		
Trade Liabilities		23,000		
Balance on Profit and Loss Account		2,000		
		£125,000		£125,000

The profits have remained at about the same figure for a number of years, and have averaged about £3000 a year before charging Debenture Interest.

If a merger of the interests of the above two Companies is desired, it can probably best be effected by a new Company being formed to purchase the Ordinary Shares of both existing Companies from the various owners, issuing in exchange its own shares as consideration therefor.

The Balance Sheet of the new Holding Company, after the transaction had been completed, would appear as follows :

BALANCE SHEET

Share Capital authorised and issued— 68,750 Ordinary Shares of £1 each	£68,750	Cost of the whole of the Share Capital of Company " C ", namely, 100,000 Ordinary Shares of £1 each, *i.e.* at 10s. a share	£50,000
		Cost of the whole of the Ordinary Share Capital of Company " D ", namely, 50,000 Ordinary Shares of £1 each, *i.e.* at 7s. 6d. per share	18,750
	£68,750		£68,750

No change would take place in the constitution or capitalisation of Companies " C " or " D ". There would merely be a change in the personnel of the shareholders of these Companies.

The probable objections to alternative forms of merger are briefly noted below.

If Company " C " were to act as a Holding Company and were to issue further Ordinary Shares in exchange for the Ordinary Shares in Company " D ", this operation would unduly inflate the totals of the Balance Sheet of Company " C ", bearing in mind that the real value (as distinct from the nominal

value) of the existing Ordinary Shares in Company "C" is only 10s., and of the shares in Company "D" only 7s. 6d.

A similar objection would apply to a Scheme whereunder Company "D" purchased from the various holders the Ordinary Shares of Company "C", issuing its own Ordinary Shares as consideration therefor.

The objection to a scheme whereunder Company "D" might buy the *business* of Company "C" and make an issue of further Ordinary Shares as consideration therefor is that the existing Ordinary Shareholders in Company "C" would receive a security in exchange which had ranking in front of it a Debenture and a Preference Issue. And, further, the new Combine might be prejudiced, in raising fresh Loan Capital at any time, by the fact that it had a Debenture Issue outstanding.

The objection to Company "C" buying the *business* of Company "D" is that the Debenture and Preference Share Capital of Company "D" would thereupon require to be paid off at par upon Company "D" going into liquidation. This benefit to the Debenture Holders and Preference Shareholders of Company "D" represents, in effect, a loss to the Ordinary Shareholders of that Company. This point has already been explained in Example I. relating to Companies "A" and "B".

EXAMPLE III

The following is a Summary of the affairs of two Companies which own businesses of a similar character, and which desire to merge their interests.

COMPANY "E"

BALANCE SHEET

Share Capital authorised and issued—		Fixed Assets	£80,000
100,000 Ordinary Shares of £1 each	£100,000	Floating Assets	45,000
Trade Liabilities	23,000		
Balance on Profit and Loss Account	2,000		
	£125,000		£125,000

The Net Profits do not show much variation as between one year and another, and average £15,000 per annum.

COMPANY "F"

BALANCE SHEET

Share Capital authorised and issued—		Fixed Assets	£40,000
100,000 Ordinary Shares of £1 each	£100,000	Floating Assets	40,000
Trade Liabilities	30,000	Goodwill (at figure originally paid therefor)	20,000
		Debit Balance on Profit and Loss Account	30,000
	£130,000		£130,000

The operating results have been poor, and for some years have varied between a loss of £3000 and a profit of £3000. The results, taking a somewhat lengthy period as a whole, show a gradual improvement.

If a merger of the interests of the above two Companies is desired, it can probably best be effected by Company "F" selling its business to Company "E", the latter Company issuing further Ordinary Share Capital as consideration therefor. Company "F" would then be wound up, and the shares in Company "E" which it had acquired would be distributed among its own Shareholders.

It may, perhaps, be fair to assume that the value of an existing £1 Ordinary Share in Company "E" is worth 27s. 6d. and a £1 Ordinary Share in Company "F" is worth 7s. On this latter basis, the whole of the Issued Share Capital of Company "F", namely, £100,000, would be worth £35,000. If Company "E" were to acquire the business of Company "F" for £35,000, and were to issue its own Ordinary Shares as consideration therefor, it would only have to issue shares to the nominal amount of £25,455, as each of these £1 shares would be worth 27s. 6d.

The Balance Sheet of Company "E", after the purchase had been carried through, would appear as follows:

BALANCE SHEET

Share Capital authorised and issued—			Fixed Assets—		
Original Issue of 100,000 Shares of £1 each . .	£100,000		Previously owned by Company "E" .	£80,000	
Further Issue for purpose of acquiring the business previously owned by Company "F"	25,455	£125,455	Acquired from Company "F" .	25,000	£105,000
Premium on latter Issue . .		9,545	Floating Assets—		
Trade Liabilities . . .		23,000	Originally owned by Company "E" .	£45,000	
Profit and Loss Account Balance		2,000	Acquired from Company "F" (*i.e.* the excess of the total Floating Assets of Company "F" over the Trade Liabilities of that Company) . .	10,000	55,000
		£160,000			£160,000

From the above figures it will be noted that Company "E" is acquiring from Company "F", for the sum of £35,000, the Assets, less Liabilities, which stand in the books of Company "F" at £70,000, namely:

Fixed Assets	. . .	£40,000
Floating Assets	. . .	40,000
Goodwill	. . . .	20,000
		£100,000
Less Liabilities	. .	30,000
		£70,000

There is, therefore, a difference between the two sums, of £35,000, and Company "E", in apportioning the purchase price in its own books, would consider that this £35,000 represented to Company "F" a loss of the whole of the Goodwill, namely, £20,000, and a loss of £15,000 in respect of the Fixed Assets. The Floating Assets would presumably be worth their face value.

Company "F", on going into liquidation, would utilise the Floating Assets which it had retained, namely, £30,000, in discharging the Trade Liabilities of the like amount, and it would then be free to distribute its one remaining asset, namely, 25,455 shares in the "E" Company, among its own Shareholders, the nominal value of whose holding is £100,000.

By the above means the full advantages obtainable from a complete amalgamation of the two businesses would be reaped.

Objections to other alternative forms of merger may be briefly noted.

If Company "F" were to buy the shares of Company "E" from the individual shareholders, it would have to issue a very large number of additional shares, bearing in mind that its existing shares are only worth about 7s.

each, whereas the shares of Company " E " are presumed to be worth 27s. 6d. each. The purchase would thus unduly inflate the Balance Sheet of Company " F ".

Another alternative course would be for Company " E " to purchase the whole of the Share Capital in Company " F ". The full advantages of a merger could not, however, be obtained under a Holding Company Scheme of this character as would be the case under a Scheme of Complete Amalgamation. Further, the Balance Sheet of Company " F " would continue to be a very weak one, containing, as it does, a figure of £20,000 for Goodwill when no value could be said to reside in the Goodwill; and also a debit balance on Profit and Loss Account of £30,000. From the point of view of the obtaining of credit, or of the raising of Loans, therefore, the position of Company " F " would be weak, whereas if the Assets of that Company were merged with those of Company " E ", the larger Undertaking which would exist as the result of this merger would be in a much stronger position from a financial point of view.

Another alternative would be for Company " F " to purchase the *business* of Company " E ". The objection to this course is that it would be a case of the weaker buying the stronger, or, in other words, the smaller buying the larger.

EXAMPLE IV

The following is a Summary of the affairs of two Companies which own businesses of a similar character, and which desire to merge their interests.

COMPANY "G"

BALANCE SHEET

Share Capital authorised and issued—			Fixed Assets	£80,000
50,000 Ordinary Shares of £1 each	£50,000		Floating Assets	45,000
30,000 5% Preference Shares of £1 each	30,000			
		£80,000		
4% Debenture Capital (not redeemable at or by any fixed date)		20,000		
Trade Liabilities		23,000		
Balance on Profit and Loss Account		2,000		
		£125,000		£125,000

The profits remained at about the same figure for a number of years, and averaged about £3000 a year before charging Debenture Interest.

COMPANY "H"

BALANCE SHEET

Share Capital authorised and issued—		Fixed Assets	£40,000
100,000 Ordinary Shares of £1 each	£100,000	Floating Assets	40,000
Trade Liabilities	30,000	Goodwill (at figure originally paid therefor)	20,000
		Debit Balance on Profit and Loss Account	30,000
	£130,000		£130,000

The operating results have been poor, and for some years have varied between a loss of £3000 and a profit of £3000. The results, taking a somewhat lengthy period as a whole, show a gradual improvement.

If a merger of the interests of the above two Companies is desired, it can probably best be effected by Company " H ", as a preliminary step, writing off such of its Capital as is unrepresented by assets. It may perhaps be fair to assume that the value of an Ordinary Share of £1 in Company " H " is worth 7s., and if on this basis Company " H " were to write its Share Capital down, its Balance Sheet would appear as follows:

BALANCE SHEET

Share Capital, authorised and issued— 100,000 Ordinary Shares of 7s. each	£35,000	Fixed Assets	£25,000
Trade Liabilities	30,000	Floating Assets	40,000
	£65,000		£65,000

When Company " H " had reconstructed itself in the above manner, it could then create more Ordinary Share Capital ranking *pari passu* with its existing Share Capital, and issue such Share Capital as consideration for acquiring, from the individual shareholders of Company " G ", their holdings.

In view of the relatively small profits of Company " G ", the Ordinary Shares of that Company may well be worth no more than 7s. 6d. per £1 share. If, therefore, Company " H " were to acquire the whole of such shares, namely, 50,000, these would only be worth £18,750, and in respect of them it would therefore issue its further Ordinary Capital of the nominal amount of £18,750.

The Balance Sheet of Company " G " would, of course, be unaltered by the transaction, as nothing would be changed except the personnel of the Ordinary Shareholders.

The Balance Sheet of Company "H", after the transaction had been completed, would appear as follows:

BALANCE SHEET

Ordinary Share Capital authorised and issued—			Fixed Assets (as written down)	£25,000
100,000 Shares written down to 7s. a share	£35,000		Floating Assets	40,000
18,750 new Ordinary Shares of £1 each issued as consideration for the purchase of the Ordinary Share Capital in Company "G"	18,750		Cost of 50,000 Ordinary Shares of £1 each in Company "G" at 7s. 6d. a share	18,750
		£53,750		
Trade Liabilities		30,000		
		£83,750		£83,750

Objections to other alternative forms of merger may be briefly noted.

It would, of course, be possible for Company "G" to write down its Ordinary Share Capital, and then to acquire the Ordinary Shares in Company "H". This would, however, involve the purchase of a larger Interest by a smaller Interest. Further, an addition to the Assets and the Ordinary Share Capital of Company "G" would have the effect of improving the security for the Debentures and Preference Shares of that Company. By reason of the additions to the Share Capital and the Assets of Company "H", in accordance with the form of merger already recommended, the power of that Company to obtain loans from Bankers and others, should such a course be advisable at any future time, would be strengthened, especially bearing in mind that Company "H" has no Debentures outstanding.

The objection to a Complete Amalgamation, to be effected by Company "G" purchasing the *business* of Company "H" and issuing its own shares as considera-

tion therefor, is that these assets would form additional security for the existing Debenture Capital of Company "G", and would not therefore represent such good "cover" for the raising of loans, if such were desired. Further, the existing Shareholders of Company "H", who would be offered the additional Ordinary Shares which would be issued by Company "G", might not like to receive a share which had other securities—*i.e.* Preference Shares and Debentures—ranking in front of it.

The objection to Company "H" purchasing the *business* of Company "G" is, of course, that, in such circumstances, the Debenture and Preference Capital of Company "G" would require to be repaid at par, and the use of this Capital at comparatively low rates of interest and dividend would be lost.

EXAMPLE V

The following is a Summary of the affairs of two Companies which own businesses of a similar character, and which desire to merge their interests.

COMPANY "I"

BALANCE SHEET

Share Capital authorised and issued—		Fixed Assets	£80,000
100,000 Ordinary Shares of £1 each	£100,000	Floating Assets . . .	45,000
Trade Liabilities . . .	23,000		
Balance on Profit and Loss Account	2,000		
	£125,000		£125,000

The net profits do not show much variation as between one year and another, and average £5000 per annum.

COMPANY "J"

BALANCE SHEET

Share Capital authorised and issued—		Fixed Assets	£40,000
100,000 Ordinary Shares of £1 each	£100,000	Floating Assets . . .	40,000
Trade Liabilities . . .	30,000	Goodwill (at figure originally paid therefor) . . .	20,000
		Debit Balance on Profit and Loss Account . . .	30,000
	£130,000		£130,000

The operating results have been poor, and for some years have varied between a loss of £3000 and a profit of £3000. The results, taking a somewhat lengthy period as a whole, show a gradual improvement.

If a merger of the interests of the above two Companies is desired, it can probably best be effected by a new Company being formed to take over the *businesses* of both existing Companies, thus consummating a Complete Amalgamation.

By this means the full benefits of a merger may be obtained.

In view of the comparatively poor earnings of Company " I ", it seems fair to consider that the value of that Company's £1 shares may only be 10s. a share. This is equivalent to attributing a value to the whole of the Share Capital, or, in other words, to the businesses as such, of £50,000.

With regard to Company " J ", in view of the debit balance on Profit and Loss Account, also of the poor earnings, and, further, of the fact that a substantial sum appears in the Balance Sheet under the head of " Goodwill " which can no longer be said to have any value, it is clear that the real value of a £1 share is very considerably less than the nominal value. It might not be unfair to attribute to each £1 share a value of no more than 7s., and, on this basis, the real value of the whole of the Share Capital of Company " J " might be considered as £35,000. In other words, this latter figure may be regarded as being the value of the assets less liabilities of Company " J ".

The purchase price paid by the new Company for the business of Company " I ", namely, £50,000, would be apportioned as follows :

Fixed Assets	£28,000
Balance of Floating Assets, after allowing Company " I " to retain a sufficient sum to discharge the Trade Liabilities of £23,000 . . .	22,000
	£50,000

The purchase price of £35,000 paid by the new Company for the business of Company "J" would be allocated as follows:

Fixed Assets	£25,000
Floating Assets after deducting from the total of such Assets a sum sufficient to enable Company "J" to discharge its Trade Liabilities of £30,000	10,000
	£35,000

The Balance Sheet of the new Company, after the transaction had been completed, would appear as follows:

BALANCE SHEET

Share Capital, authorised and issued, in shares of £1 each—		Fixed Assets acquired from Company "I" . . .	£28,000	
Issued to the "I" Company as consideration for the purchase of its business .	£50,000	Fixed Assets acquired from Company "J" . . .	25,000	
Issued to the "J" Company as consideration for the purchase of its business .	35,000			£53,000
		Floating Assets acquired from Company "I" . .	£22,000	
		Floating Assets acquired from Company "J" . .	10,000	
				32,000
	£85,000			£85,000

The "I" Company would then go into liquidation and would distribute the 50,000 shares of the new Company among the holders of its Ordinary Capital of 100,000 shares. Similarly, the "J" Company would go into liquidation and distribute 35,000 shares of £1 each among the holders of its Ordinary Shares totalling £100,000 nominal.

There are, of course, alternative forms which the merger might take. For example, Company "I" might

buy the business of Company " J ". In view, however, of the fact that the present Ordinary Shares of Company " I " are worth considerably less than their par value, such a purchase would involve the inflation of the Balance Sheet of Company " I ", unless, indeed, Company " I " chose, as a preliminary measure, to write down its Share Capital.

The purchase of the business of Company " I " by Company " J " would be a case of the smaller swallowing the greater.

Other alternatives would be that one of the existing Companies should be chosen as a Holding Company and should acquire the shares of the other Company, issuing additional shares of its own as consideration therefor. Bearing in mind, however, the fact that the shares of both Companies are worth considerably less than their par value, such a step would cause an inflation in the Balance Sheet of the Holding Company, unless that Company, as a preliminary measure, were to write down its Share Capital.

APPENDIX B

POOLING AGREEMENT RELATING TO THE PROFITS OF CERTAIN INDUSTRIAL BUSINESSES

PRO FORMA EXAMPLE SHOWING HOW THE CONTRIBUTIONS OF THE PARTIES TO THE POOL ARE ARRIVED AT

POOLING AGREEMENT RELATING TO THE PROFITS OF CERTAIN INDUSTRIAL BUSINESSES

PRO FORMA EXAMPLE SHOWING HOW THE CONTRIBUTIONS OF THE PARTIES TO THE POOL ARE ARRIVED AT

STATEMENT I.

Showing how the Profits of one of the Parties, for the period chosen as the standard under the Pooling Agreement (i.e. the three years to 31*st December* 1929) *are arrived at.*

	Year 1927		Year 1928		Year 1929	
	£	£	£	£	£	£
NET PROFITS available for dividend, as shown by the Accounts of the Limited Company which owns the business in question		28,362		26,437		29,824
ADD						
DEPRECIATION OF FIXED ASSETS charged by the Company in arriving at the foregoing profits—the Pooling Agreement stipulating that the charge to be made shall be that which is allowed by the Inland Revenue Authorities for Income Tax purposes (see deduction below). . .		2,070		2,320		2,560
ARREARS OF MAINTENANCE EXPENDITURE, charged in arriving at the profits of 1927, but relating to previous years, now written back . .		1,926				
DIRECTORS' FEES charged in arriving at above profits, now written back, as the Pooling Agreement provides that the Profits, both for the period taken as a basis and also for the period of the Pool, shall be arrived at before charging Directors' fees		1,250		1,250		1,250

Interest paid on Loans, charged in arriving at above profits, but now written back, as, under the terms of the Pooling Agreement, Loans are to be considered as part of the Capital employed in the business, and the profits are therefore to be calculated before charging such interest		426		587		525
Income Tax charged in arriving at foregoing profits, now written back, as the Pooling Agreement provides that the profits are to be computed before making any deduction under this head		5,430		5,750		5,870
		39,464		36,344		40,029
DEDUCT						
Depreciation of Fixed Assets, on basis allowed by the Inland Revenue Authorities for Income Tax purposes	1,453		1,397		1,432	
Interest and Dividends received on Stock Exchange Securities, included in the foregoing Profits but now deducted, as, in accordance with the Pooling Agreement, this class of income is to be excluded in arriving at the profits to be pooled, as it does not represent earnings of the business as such	1,260	2,713	1,370	2,767	1,410	2,842
Net Profits as adjusted		36,751		33,577		37,187

STATEMENT II.

Showing how the Standards of each of the Parties under the Pooling Agreement are arrived at.

The profits of the *first party* to the Pool, for the three years forming the standard, adjusted in accordance with the terms of the Pooling Agreement, as shown on Statement I., are:

1927	£36,751
1928	33,577
1929	37,187
	3)107,515
Average for the three years	£35,838

Let it be assumed that the average profits of the *second party* to the Pooling Agreement adjusted in the same manner are £28,296

And let it be assumed that the corresponding figure in the case of the *third party* is 24,353

The ratios which each of these three figures bears to the total of all three may be expressed by the following percentages:

	Amount.	Percentage.
First Party	£35,838	40·5 per cent
Second Party	28,296	32·0 ,,
Third Party	24,353	27·5 ,,
	£88,487	100 per cent,

and it is these percentages of the total profits paid into the Pool in respect of each year of its operation which the parties are respectively entitled to draw out.

STATEMENT III

STATEMENT III.

Showing how the Contribution of the First Party to the Pooling Agreement, for the first year under the Agreement, is arrived at.

		Year 1930.
NET PROFITS available for dividend, as shown by the Accounts of the Company in question		£32,876
ADD		
DEPRECIATION charged in arriving at foregoing profits—the Pooling Agreement stipulating that the charge for pooling purposes shall be computed on the basis allowed for Income Tax purposes (see deduction below)		2,890
INTEREST PAID ON LOANS, charged in arriving at the foregoing profits and now written back—for the reasons given in Statement I.		746
INCOME TAX charged in arriving at foregoing profits, now written back, in accordance with the terms of the Pooling Agreement		5,210
EXCESS OF BAD DEBTS, charged in arriving at foregoing profits, over and above 1 per cent of the sales of the year 1930, disallowed under the terms of the Pooling Agreement		486
		£42,208
DEDUCT		
DEPRECIATION—on basis allowed by Inland Revenue Authorities for Income Tax purposes	£1,486	
INTEREST AND DIVIDEND RECEIVED on Stock Exchange Securities included in foregoing profits and now deducted, for reasons given in Statement I.	987	

ALLOWANCE IN RESPECT OF ADDITIONAL CAPITAL employed in the business during 1930 as compared with the Capital employed at 31st December 1929—at the rate of 6 per cent on such additional Capital, in accordance with the provisions of the Pooling Agreement (see Note below)	643	
PROFITS OF A NEW BUSINESS (acquired by the Company in 1930) and included in the foregoing profits now deducted, as the other parties to the Pooling Agreement decided (as they were entitled to do under the terms of the Agreement) that the Capital employed in such new business and the profits earned therefrom should not be brought into the ambit of the agreement	1,230	
		4,346
Profits, as adjusted, to be contributed to the Pool		£37,862

NOTE.—The additional Capital employed would, in practice, be arrived at by a somewhat elaborate and detailed calculation, of which it is not thought necessary to give an example here. In the case under consideration it may be assumed that the "Capital employed" has been increased by reason of

(*a*) The profits of 1930 exceeding the dividend distributions.
(*b*) Additional money being borrowed on Loan Account; loans being treated as "Capital", and the interest paid thereon being written back in arriving at the profits.
(*c*) Some of the Stock Exchange securities having been sold in 1930, and the proceeds used in the business.

On the other hand, the "Capital employed" would be decreased by the Capital put into the new business which, as stated above, was acquired in 1930 and was excluded from the ambit of the Pooling Agreement.

STATEMENT IV.

Showing the Contributions to and division of the Pool in respect of the year 1930.

The Profits to be contributed to the Pool by the *first party*, per the calculations in Statement III., are	£37,862
Let it be assumed that the Profits to be contributed by the *second party*, arrived at in similar manner, are	25,437
And let it be assumed that the corresponding profits to be contributed by the *third party* are	27,386
The Total Contributions to the Pool are therefore	£90,685

And these contributions are to be shared, in accordance with the terms of the Pooling Agreement, as follows:

By the first party, 40·5 per cent, namely	£36,728
By the second party, 32·0 per cent, namely	29,019
By the third party, 27·5 per cent, namely	24,938
Total, as above	£90,685

In practice, the parties would not receive and pay the actual sums set out above, but merely the differences.

The first party, having to contribute to the Pool £37,862 and to receive out of the Pool £36,728, has to *pay* the difference of		£1,134
The second party, having to contribute to the Pool £25,437 and to receive out of the Pool £29,019, has to *receive* the difference of		3,582
The third party, having to contribute to the Pool £27,386 and to receive out of the Pool £24,938, has to *pay* the difference of		2,448
The settlement would therefore be effected by the first party paying to the second party	£1,134	
And by the third party paying to the second party	2,448	
The second party would thus receive, as above	£3,582	

APPENDIX C

PRO FORMA EXAMPLE ILLUSTRATING THE METHOD OF VALUING, FOR AMALGAMATION PURPOSES, AN INDUSTRIAL UNDERTAKING OWNED BY A LIMITED COMPANY

PRO FORMA EXAMPLE ILLUSTRATING THE METHOD OF VALUING, FOR AMALGAMATION PURPOSES, AN INDUSTRIAL UNDERTAKING OWNED BY A LIMITED COMPANY

SUMMARY OF BALANCE SHEETS AS PRESENTED TO THE SHAREHOLDERS

	31st Dec. 1924	31st Dec. 1925	31st Dec. 1926	31st Dec. 1927	31st Dec. 1928	31st Dec. 1929
LIABILITIES SIDE—	£	£	£	£	£	£
Issued Share Capital	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
Trade and other Creditors	30,000	30,000	30,000	30,000	30,000	30,000
Free Reserves (including undistributed balance on Profit and Loss Account), say	200,000	220,000	240,000	260,000	280,000	300,000
	1,230,000	1,250,000	1,270,000	1,290,000	1,310,000	1,330,000
ASSETS SIDE—						
Land, Buildings and Plant, *less* Depreciation as provided for by the Company	350,000	360,000	370,000	380,000	400,000	400,000
Trade Debtors	100,000	110,000	110,000	110,000	120,000	80,000
Stocks, as valued by the Company for Balance Sheet purposes	600,000	600,000	620,000	630,000	620,000	700,000
Cash	30,000	30,000	30,000	30,000	30,000	30,000
Goodwill	150,000	150,000	140,000	140,000	140,000	120,000
	1,230,000	1,250,000	1,270,000	1,290,000	1,310,000	1,330,000
The Net Profits of the Company shown by its audited Accounts as available for dividend on the Share Capital, after providing for depreciation and for Income Tax not recoverable by deduction from the Shareholders in paying dividends, and after charging Directors' remuneration, but before making any appropriations to Free Reserves, were, let it be assumed, as follows	..	180,000	190,000	200,000	190,000	250,000

Assuming for the moment that no adjustments were made either to the book figures representing Capital employed or Profits earned, as a result of the valuation of Buildings, Plant, etc., by an independent expert valuer, or as a result of independent accountants' special investigation into the Profits, etc., and that the business was valued on the basis described in Chapters V., VIII., IX., X., and XI., the value at the 31st December 1929 would be arrived at as follows:

	Average.	31st Dec. 1924	31st Dec. 1925	31st Dec. 1926	31st Dec. 1927	31st Dec. 1928	31st Dec. 1929
		£	£	£	£	£	£
CAPITAL EMPLOYED IN THE BUSINESS, EXCLUSIVE OF GOODWILL—							
Land, Buildings and Plant		350,000	360,000	370,000	380,000	400,000	400,000
Debtors		100,000	110,000	110,000	110,000	120,000	80,000
Stocks		600,000	600,000	620,000	630,000	620,000	700,000
Cash		30,000	30,000	30,000	30,000	30,000	30,000
		1,080,000	1,100,000	1,130,000	1,150,000	1,170,000	1,210,000
Less							
Trade and other Creditors		30,000	30,000	30,000	30,000	30,000	30,000
CAPITAL EMPLOYED		1,050,000	1,070,000	1,100,000	1,120,000	1,140,000	1,180,000
Average "Tangible" Capital employed during each year (*i.e.* the mean between the Capital employed at the beginning and end of each year)	£1,109,000	..	1,060,000	1,085,000	1,110,000	1,130,000	1,160,000
NET PROFITS EARNED—as before	£202,000	..	180,000	190,000	200,000	190,000	250,000

Deduct

(Say) 9 per cent on Average Tangible Capital employed (representing a commercial return)	99,810
Balance, representing Super Profits	£102,190

Super Profits, capitalised at (say) seven years' purchase in order to arrive at value of Goodwill	£715,330
Value of Net Tangible Assets at 31st December 1929, on basis of the Balance Sheet figures	1,180,000
TOTAL VALUE OF THE BUSINESS AT 31ST DECEMBER 1929, assuming that the Balance Sheet figures of Tangible Assets and the Profits as shown by the issued Profit and Loss Accounts were accepted as correct without any adjustment	£1,895,330

As provided, however, in the assumed Scheme for Amalgamation, the Land, Buildings, Plant, etc., are to be valued by independent Valuers; and further, this value is to be taken into account in arriving at the amount of real Capital employed in the business, for the purpose of assessing the value of the Goodwill.

Similarly, Stocks in Hand at the 31st December 1929 are to be valued on a uniform basis; and furthermore, the true Capital employed in the business during the years taken as a basis for arriving at the value of the Goodwill will also have to be adjusted if stocks have been valued in such years at less than their cost.

Let it be assumed that as a result of the adjustments mentioned above in connection with the values of Land, Buildings, Plant, Machinery and Stocks, the amended figures are as follows:

	31st Dec. 1924	31st Dec. 1925	31st Dec. 1926	31st Dec. 1927	31st Dec. 1928	31st Dec. 1929
	£	£	£	£	£	£
Land, Buildings and Plant (taking the valuation figures at 31st December 1929 and "working back" from these by taking into account the additions made during each year of the series, and calculating a fair depreciation charge as advised by the Valuers)	530,000	560,000	580,000	595,000	618,000	620,000
Stocks in Hand, taken at cost	620,000	620,000	640,000	650,000	640,000	740,000
Debtors, as before	100,000	110,000	110,000	110,000	120,000	80,000
Cash, as before	30,000	30,000	30,000	30,000	30,000	30,000
	1,300,000	1,320,000	1,360,000	1,385,000	1,408,000	1,470,000
Less Trade and other Creditors, as before	30,000	30,000	30,000	30,000	30,000	30,000
"TANGIBLE" CAPITAL EMPLOYED, as adjusted . .	1,270,000	1,290,000	1,330,000	1,355,000	1,378,000	1,440,000
Average "Tangible" Capital employed during each year (*i.e.* the mean between the figure at the beginning and end of each year) . . . *Average.* £1,341,600	..	1,280,000	1,310,000	1,342,500	1,366,500	1,409,000

The Net Profits as shown by the Company's Annual Accounts require, however, to be adjusted as shown below:

	Year to 31st Dec. 1925		Year to 31st Dec. 1926		Year to 31st Dec. 1927		Year to 31st Dec. 1928		Year to 31st Dec. 1929	
	£	£	£	£	£	£	£	£	£	£
NET PROFITS as shown by the Company's annual Accounts		180,000		190,000		200,000		190,000		250,000
ADD										
DEPRECIATION of Buildings, Plant, etc., charged by the Company in arriving at the above profits, now written back, as the revised charge for depreciation is deducted instead (see below)		34,500		46,000		39,875		34,500		33,000
INCOME TAX charged in arriving at foregoing Profits, now written back, as Income Tax is not an expense incurred in earning profits but an appropriation of profits		18,000		17,000		19,000		19,000		17,000
DIRECTORS' REMUNERATION charged by the Company in arriving at the above profits, now written back, as a revised charge is deducted instead (see below)		1,000		1,250		1,250		1,250		1,500
INCREASE OF PROFITS arising by reason of the revaluation of the Stock-in-trade at the beginning and end of each year		..		..		..		..		20,000
PENSION PAYMENTS to ex-employees made during the period, but now written back, as an adjusted charge in respect of pensions is made (see below)		3,000		3,500		3,800		3,300		3,500
LOSS owing to a defalcation, charged in arriving at the above profits, now written back, as the loss is an exceptional and non-recurring one		..		3,500		..		..		..
ARREARS OF MAINTENANCE EXPENDITURE, paid since 1st January 1925 and charged in arriving at the above profits, but relating to the period ended 31st December 1924		4,000		..		..		..		..

Expenditure on Advertising charged by the Company in arriving at the above Profits, now written back, as a substituted charge is made (see below) .		16,000		14,000		19,000		23,000		45,000
		256,500		275,250		282,925		271,050		370,000
DEDUCT										
Depreciation of Buildings, Plant, etc., as certified to be a fair and proper charge by the independent professional valuer	25,000		26,000		27,000		29,000		31,000	
Directors' remuneration; agreed fair charge in this respect, having regard to the services rendered by the Directors .	3,500		3,500		3,500		3,500		4,000	
Fair annual provision in respect of Pensions, as certified by an Actuary, calculated by reference to the numbers and ages of the Company's staff, and on the assumption that the Company's past policy in regard to the granting of Pensions will be continued . . .	12,000		13,000		13,000		14,000		15,000	
Fair annual charge in respect of Advertising, arrived at by spreading abnormal advertising expenditure over a certain period, instead of charging it against Profit and Loss Account as and when incurred, as was the Company's practice	17,000		17,000		18,000		19,000		30,000	
Profit on the purchase and sale, during one financial year, of a Stock Exchange security, included by the Company in its published profits, but now deducted as being an exceptional and Non-recurring Profit	..		1,500		..		..		..	
Total Deductions . . .		57,500		61,000		61,500		65,500		80,000
Net Profits as adjusted . *Average.* £226,045		199,000		214,250		221,425		205,550		290,000

The average Net Profits adjusted as shown on the previous page amount to	£226,045
If from this figure is *deducted* an amount equivalent to 9 per cent on the average " Tangible " Capital employed of £1,341,600 (representing a commercial return), namely	120,744
A Balance remains representing " Super Profits " of	£105,301
If these " Super Profits " are capitalised at seven years' purchase, a value of the Goodwill is arrived at of	£737,107
The value of the net " Tangible " Assets at 31st December 1929, on the basis of the various valuations made, amounts to	1,440,000
The total value of the business at 31st December 1929, on the basis of the adjusted figures, is therefore shown to be	£2,177,107

The above value compares with a value arrived at before any adjustments in the figures were made, of £1,895,330.

NOTE.—It will be appreciated that in practice the adjustments would affect more of the figures than is shown in the foregoing example. For instance, the amount of the creditors is treated as requiring no adjustment, whereas in practice this item would almost certainly require amendment. The example is, however, sufficiently accurate and detailed to show the general principles involved.

APPENDIX D

THREE *PRO FORMA* EXAMPLES OF THE CAPITALISATION OF LIMITED COMPANIES

THREE *PRO FORMA* EXAMPLES OF THE CAPITALISATION OF LIMITED COMPANIES

EXAMPLE I

THE summarised Balance Sheet set out below represents the combined Assets and Liabilities of two manufacturing businesses which have become amalgamated. In connection with the amalgamation a new Limited Company is to be formed to take over both businesses, and the capitalisation of such Limited Company has to be considered.

In connection with the valuation of the goodwill of both businesses totalling £83,000 as shown below, it may be mentioned that this represents between five and six years' purchase of the super-profits left over after charging against the average profits of a series of past years a sum representing 9 per cent on the value of the tangible net assets employed in the businesses.

The calculation is as follows:

Profits	£38,000
Less 9 per cent on £257,000	23,130
Super-Profits	£14,870

Five years' purchase of Super-Profits . . .	£74,350
Six " " " . . .	89,220

COMBINED VALUATION BALANCE SHEET

Creditors	£30,000	Freehold Land and Buildings	£100,000
Balance, representing excess of Assets (including Goodwill) over Liabilities	340,000	Fixed and Movable Plant and Equipment	70,000
		Stock-in-trade and Work-in-progress	60,000
		Debtors	45,000
		Cash at Bankers	12,000
		Goodwill	83,000
	£370,000		£370,000

For the purpose of simplicity, it has been assumed that the Capital employed during the period taken as a standard for the purpose of calculating the value of the Goodwill is exactly equal to the Capital employed at the date as at which the Valuation Balance Sheet was prepared. And further, it has been assumed that the anticipated net profits (after charging depreciation but before charging Income Tax) will amount to the same figure as in the years referred to above as being taken as a basis, namely, £38,000.

It is suggested that a convenient form of capitalisation, under the circumstances, might be as follows:

£100,000 in $5\frac{1}{2}$ per cent First Mortgage Debentures issued at par.

100,000 in 7 per cent Cumulative and Participating Preference Shares of £1 each.

140,000 in Ordinary Shares of £1 each.

£340,000 excess of Assets over Liabilities, as above.

As regards the Debentures, it might be provided that these should not be redeemable by any fixed date, but that the Company has the right to redeem at any time

at a premium of 10 per cent on giving six months' notice. Similarly, if a Liquidation ensues, the Debentures would be redeemable at a premium of 10 per cent. Provision might also be made whereunder the Company would be allowed to issue a further £50,000 Debentures ranking *pari passu* with the existing Issue, but that no such further Debentures should be issued unless there had already been issued further Preference or Ordinary Shares of a nominal amount equal to twice the amount of the Debentures.

As regards the Preference Shares, the holders of these would be entitled, in addition to the fixed and cumulative dividend of 7 per cent, to the following further participation in profits.

In any year in which the dividend paid on the Ordinary Shares exceeded 12 per cent, the Preference Shareholders would be entitled to a *pro rata* participation in such excess dividend, but with the proviso that this participation could not in any year exceed 3 per cent, making, with the fixed dividend of 7 per cent, a total rate of 10 per cent. As an example, if in any year a dividend on the Ordinary Shares was paid of 14 per cent, the Preference Shareholders would receive, in addition to their fixed dividend of 7 per cent, a further participation of 2 per cent.

It might be provided that further Preference Shares could be issued ranking *pari passu* with the existing issue, but only on the basis that for every four Preference Shares so issued there were issued, or had already been issued, six new Ordinary Shares.

Each Preference Share and each Ordinary Share would carry one vote.

On a Liquidation, after the Debenture-holders and other Creditors had been satisfied, the Preference Shareholders would first receive the par value of their Capital. Any surplus then remaining would be divided *pro rata*

between the Preference and Ordinary Shareholders, with the proviso that as regards the Preference Shareholders such surplus is not to amount to more than 5s. a share, making the maximum return in respect of a Preference Share 25s.

The following comments may be made on the above form of Capitalisation.

As regards the DEBENTURES, these carry a comparatively low rate of interest, which, of course, is an advantage to the Shareholders. At the same time, from the Debenture-holders' point of view, the security, as regards both Capital and Income, is very good. It will be observed that in Land and Buildings alone (*i.e.* apart from Plant and Machinery) the Company has fixed assets equal to the amount of the Debenture Debt, and that as regards the net tangible assets as a whole the Debentures are covered, from a Capital point of view, more than two and a half times over. The Debenture-holders are further protected by the restriction which would exist, as referred to above, in the right to issue further debentures ranking *pari passu* therewith, and also in the provision that if the Company at any time wished to redeem the Debentures, it could only do so by paying a premium of 10 per cent.

It will be noticed that no provision is made for redeeming the Debentures by means of a Sinking Fund accumulated out of profits. The reason for this is that it is hoped that the business would continue to expand; and, in such event, further Capital would be needed from time to time. It would therefore be bad finance for the Company to be engaged simultaneously in paying off Debentures carrying a low rate of interest and raising fresh money at, possibly, a higher rate of interest or dividend.

From the point of view of income, the Debentures

are very well secured, as the profits of £38,000 are sufficient to cover the Debenture Interest between six and seven times over.

In view of the strong position held by the Debentures, both from a Capital and an Income point of view, it is suggested that the further strengthening which might be effected by means of redeeming the Debentures, over a period, by means of a Sinking Fund created out of profits, is uncalled for.

As regards the Preference Shares, the alternative might have been considered of giving these a fixed rate of dividend only, instead of combining, with the fixed dividend, a further participation in profits.

It would seem, however, that if the shares merely enjoyed a fixed dividend of 7 per cent they would hardly form a sufficiently attractive security to be worth par, bearing in mind that a considerable Debenture Debt ranks in front of them, and, further, that such Debenture Debt is not subject to gradual reduction out of profits by means of a Sinking Fund. The alternative, of course, might be considered of dispensing with the participation in surplus profits but raising the fixed rate of dividend on the Preference Shares to, say, 8 per cent or 9 per cent. From the point of view, however, of appearances, a cumulative Preference Share carrying so high a rate of dividend as 8 per cent or 9 per cent may be objectionable; it is calculated to give the impression that the Company's standing and credit cannot be first class, if such liberal terms have to be accorded to Preference Shares.

The attraction of a Preference Share which enjoys, as well as a fixed dividend, a participation in surplus profits, is that it appeals to two classes of Investor—the class of investor which looks, primarily, for a good security from a Capital and Revenue point of view, but

is willing to forgo any prospect of increased income, and the other class of investor which is attracted by a share which has some speculative element such as a possible enhancement in the income would afford.

As regards the ORDINARY SHARES, it will be seen that these, being greater in number than the Preference Shares, carry the voting control of the Company. Further, the capitalisation is such that the Ordinary Shares should be worth at least par if the earning capacity of the Company is maintained.

If the assumed profits are continued, namely .		£38,000
there would be absorbed—		
By Debenture Interest . . .	£5500	
By Fixed Dividend on the Preference Shares . . .	7000	
		12,500
Leaving a balance of		£25,500
Of the above sum the Company could appropriate to General Reserve Account, say . .		5,000
Leaving available for dividend and "carry forward" a balance of . . .		£20,500
12 per cent on the Ordinary Share Capital would absorb		16,800
Leaving a balance of		£3,700
A further 1 per cent on the Ordinary Shares would absorb . . .	£1400	
And a further 1 per cent on the Preference Shares would absorb .	1000	
		2,400
Leaving to be carried forward to the next financial year a balance of		£1,300

On the above basis the total dividend on the Ordinary Shares, namely, 13 per cent, is a high one, but it must be remembered that, relatively speaking, the Ordinary Share Capital is speculative, as there ranks in front of it

considerable amount of Preference Capital and also of Debenture Capital.

The above method of capitalisation has the special advantage of enabling the owner of each Vendor business to whom the above securities are allotted to dispose of a large portion of his interest (namely, that represented by the Debentures and the Preference Shares) either for cash or by putting the securities into Family or other Trusts, and at the same time retaining, through the medium of the Ordinary Shares, a relatively large voice in the future control of the Company.

EXAMPLE II

The summarised Balance Sheet set out below represents the combined Assets and Liabilities of two businesses operating a number of retail shops. These businesses have become amalgamated by means of a new Limited Company being formed to acquire them and to issue its Capital as consideration therefor.

In connection with the Goodwill of both businesses totalling £109,000, as shown below, it may be mentioned that this represents between five and six years' purchase of super-profits left over after charging against the average profits of a series of past years a sum representing 8 per cent of the value of the net tangible assets employed in the business.

This calculation is as follows :

Net Profits after providing for depreciation in respect of Premises and for accruing dilapidations in connection with leasehold property rented, but before charging Income Tax	£70,000
Less 8 per cent on net tangible Capital employed in the business, namely, £628,000 . . . . equals	50,240
Super-Profits . .	£19,760
Five years' purchase of the above Super-Profits equals	£98,800
Six years' purchase of the above Super-Profits equals	£118,560

COMBINED VALUATION BALANCE SHEET

Trade and other Creditors	£73,000	Freehold Premises	£26,000
Balance representing excess of Assets (including Goodwill) over Liabilities	737,000	Leasehold Premises	28,000
		Fixtures, Fittings, Furniture, etc., at Shops	76,000
		Book Debts	163,000
		Stock-in-Trade	374,000
		Cash at Bankers and In Hand	34,000
		Goodwill	109,000
	£810,000		£810,000

For the purpose of simplicity, it has been assumed that the Capital employed during the period taken as a standard for the purpose of calculating the value of the Goodwill is exactly equal to the Capital employed at the date as at which the Valuation Balance Sheet was prepared; and, further, it has been assumed that the anticipated net profits will amount to the same figure as those in the years referred to above as being taken as a basis, namely, £70,000.

It is also assumed that, to a considerable extent, the volume of the Company's business varies as between different times of the year, thus necessitating more Capital being provided at certain times than at others.

In respect of the great majority of its Shops, the Company only has a leasehold interest—the leases being in the main those for twenty-one years, and the lessee having the right to terminate at the end of seven or fourteen years. Except in a relatively few cases the Company has paid on substantial premiums for these leases. Its shops, geographically speaking, are well spread, and they are also numerous. It is believed that in the majority of cases the renewals of the leases on expiration can be obtained without the payment of any substantial premium or the raising, to any great extent, of the rent. It is the Company's practice to negotiate for a renewal of a lease (if such is required) some considerable time before the lease expires;

and in the event of a renewal on reasonable terms not being obtainable, it would be the Company's policy to acquire premises near by, in order that the Goodwill attaching to any particular shop should not be lost on the expiry of the lease. In view of the above circumstances, the Company's position in regard to the premises in which it carries on its business is not as difficult or speculative as might at first sight be imagined from a consideration of the Balance Sheet in which such heavy stocks-in-trade and such large book debts exist, but where the items in respect of freehold and leasehold premises are, relatively, so small.

It is suggested that a convenient form of Capitalisation, under the circumstances, might be as follows:

£300,000 in 7 per cent Cumulative Preference Shares of £1 each.
437,000 Ordinary Shares of £1 each.

£737,000

The Preference Shares would be entitled to their fixed dividend out of profits before any profits were available for payment of a dividend on the Ordinary Shares.

The Preference Shares would have no voting rights unless their dividend is in arrear. Under these latter circumstances, each Share to carry one vote; and in all circumstances each Ordinary Share to carry one vote.

In the event of a liquidation, the Preference Shares are first to be entitled to be paid off at par. Then the Ordinary Shares would receive the par value of their security. If any surplus assets remained, then to an amount not exceeding 2s. 6d. per £1 Preference Share, these are to be distributed to the Preference Shareholders, the balance being paid to the Ordinary Shareholders.

The Company might retain the right to issue further Preference Shares ranking *pari passu* with the existing issue, with the proviso, however, that in respect of every three Shares so issued there should also be issued at the same time, or have already been issued, at least five Ordinary Shares.

From a consideration of the Balance Sheet it will be apparent that the assets of the Company are not of a character which renders it convenient to arrange for a considerable portion of the Capital to be represented by a long term Debenture issue. The fixed assets on which such Debentures could be given a specific charge are, relatively, of trifling value.

Furthermore, as has been mentioned above, the Company's business demands the use of considerably more Capital at certain times of the year than at certain other times; and the obvious means of providing this temporary Capital is through the medium of temporary Loans from Bankers which can be paid off as soon as the necessary Capital can be withdrawn from the business. The Company's position, in negotiating for a Bank Loan, is very much stronger if there are no Debentures outstanding. It is true that the Company has few assets which it can pledge as specific security for a Bank Loan; on the other hand, it is suggested that Bankers would, on a Balance Sheet and Accounts showing a healthy position as regards assets and earnings, be willing to lend some reasonable amount temporarily without specific security. They would doubtless stipulate that the Company should not, in the meantime, pledge any of its assets or raise any other Loans.

From the point of view of the Vendors of the businesses, the Capitalisation suggested above has the merit that it allows a Vendor to dispose, if he desires it, of a

large proportion of his interest (that is to say, the portion represented by Preference Shares) without impairing his voting power, and also without sacrificing the relative proportion of his income from the business. Further, if the business continues to prosper, the Vendor would still be retaining the security which gives the highest yield, that is to say, the Ordinary Shares.

If annual profits continue to be earned of . .		£70,000
these could be applied as follows:		
In payment of the fixed dividend of 7 per cent on the Cumulative Preference Shares . .	£21,000	
In payment of a dividend on the Ordinary Shares at the rate of 10 per cent . . .	43,700	
Appropriations to General Reserve	5,000	
		69,700
Leaving a small balance to be carried forward of		£300

The following question may be asked, if a comparison be made between the basis adopted for valuing the Goodwill in Example I., *i.e.* of the manufacturing businesses, and in Example II., *i.e.* in regard to the businesses owning Retail Shops:

"Why, in the first case, is the fair commercial return on the Capital employed taken at 9 per cent, while in the second case it is taken at 8 per cent?"

It is suggested that the following good reason accounts for the difference in the rates.

The manufactures carried on in connection with the first-mentioned businesses are of a special character, necessitating a special type of buildings and special plant and equipment. If such businesses were to fall upon evil days, and the assets had, in consequence, to be sold

piecemeal, a serious loss would occur in connection with the leasehold and freehold Land and Buildings and the Fixed and Movable Plant, as these assets would be of comparatively little use for the purpose of other businesses. With respect to the second case, however, the great bulk of the assets in question are Book Debts and Stock-in-Trade. If the Company's business had declined, and in consequence some of the shops were unprofitable and had to be closed down, the book debts at such shops could, in the main, be collected, and the Stock could, presumably, be transferred to other shops. In comparison, therefore, with the Manufacturing businesses in Example I., there would not be so great a loss of Capital. This constitutes good grounds for suggesting that, in the case of Example I., the additional risk of loss should be taken into consideration by assuming the fair commercial return to be 9 per cent as compared, in Example II., with 8 per cent.

EXAMPLE III

The Summarised Balance Sheet set out below represents the Assets and Liabilities of two adjacent Collieries which have become amalgamated. The value put upon the two Collieries combined is £748,000, and this value has been arrived at on a basis of anticipated earning capacity. For the purposes of the Balance Sheet, however, the Floating Assets have been set out in detail at their worth at the date as at which the valuation of the Colliery was made; the original cost of sinking the shaft and developing the mine has been set out separately, as has similarly the cost of Buildings and Fixed Plant less depreciation. The Land and Mineral Rights in the Balance Sheet have therefore been inserted at a figure which, when added to the other Assets less the Liabilities, produces the value of the Colliery as a whole at £748,000, as referred to above.

COMBINED VALUATION BALANCE SHEET

Creditors	£23,000	Land and Mineral Rights	£352,000
Balance, being excess of Assets over Liabilities	748,000	Buildings, Fixed Plant and Equipment, *less* Depreciation	87,000
		Expenditure on Sinking Shaft and developing Mine	210,000
		Loose Equipment, including Locomotives, Wagons, etc.	38,000
		Stocks and Stores, etc.	25,000
		Coal extracted, but not yet sold	9,000
		Debtors	36,000
		Cash	14,000
	£771,000		£771,000

The profits, after meeting all repairs and upkeep, and after making provision for depreciation of such assets as

will require renewal during the life of the Colliery, but before providing for the amortisation, over the anticipated economic life of the mine, of the Capital embarked, are expected to average, per annum, £85,000.

On the basis of a Sinking Fund accumulated at 4 per cent it has been calculated that an annual charge of £6500 against the profits will make the necessary provision for the amortisation of the Capital and Development Expenditure. In order, however, to be on the conservative side, the Directors have assumed this figure to be £7000.

It is suggested that a convenient form of Capitalisation, under the circumstances, might be as follows:

£300,000	in 7 per cent First Mortgage Debentures redeemable by a cumulative Sinking Fund out of profits, such Fund being used to purchase the Debentures on the market at a price not exceeding £105 (exclusive of accrued interest) per £100 Debenture, or by annual drawings at £105.
448,000	in Ordinary Shares of £1 each.
£748,000	Total Capital.

The annual charge in respect of the Debenture Sinking Fund is to be £7000, plus a sum equivalent to interest on the Debentures already redeemed in connection with the Sinking Fund.

On the above basis, the Working Profits of would be dealt with as follows:		£85,000
Interest at 7 per cent on the £300,000 Debentures would absorb	£21,000	
The Sinking Fund on the Debentures would require	7,000	
		28,000
Leaving available for dividend on the Ordinary Shares		£57,000
The above sum would enable a dividend to be paid at the rate of 12 per cent, subject to Income Tax, absorbing		53,760
Leaving to be carried forward a sum of		£3,240

It might, however, be well to restrict the dividend to 10 per cent for a few years and to build up some liquid reserves which might be available for meeting the Debenture Interest and Sinking Fund for a year or two in the event of any prolonged strike or abnormal depression in the Industry. Incidentally, of course, there would be nothing to prevent the Company from purchasing some of its own Debentures with any surplus funds which it had available (such purchases being quite apart from those in connection with the Debenture Sinking Fund), and selling such Debentures whenever it required the cash.

It is suggested that the Debenture Issue should be a closed one, that is to say, that the Company should not be allowed to issue any further Debentures ranking *pari passu* with this issue without, of course, the consent of the holders.

From the point of view of the owners of the Collieries, it may be very convenient to receive a substantial portion of the consideration in the form of a Debenture, as this could be sold, or, alternatively, put into a family trust, the Vendors still retaining the security (namely, the Ordinary Shares), on which the bulk of the income distribution would be made and which would carry the control over the Company's affairs.

An objection to a large Debenture Issue in the case of a colliery is, of course, that in the event of the coal industry falling upon evil days, the Company may not be able to keep up the interest and Sinking Fund payments on the Debentures, and, as a result, the Debenture-holders might foreclose, and by this means the property, or at least the full control thereover, might pass from the hands of the Shareholders. At the same time, it must be borne in mind that if, instead of Debentures, Preference Shares are issued, these, being irredeemable, and ranking behind any creditors of the Company, would

require to carry a relatively high rate of dividend, or, alternatively, some participation in profits in addition to the fixed dividend.

In the case considered above, the Interest and Sinking Fund on the Debentures absorb less than one-third of the anticipated profits of the Company; and the financial position each year should be somewhat strengthened, firstly by the fact that the Debentures are gradually being redeemed, and secondly by the placing to reserve (and probable investment outside the business) of some small portion of the annual profits, in order to provide a Fund for contingencies, as suggested above.

It will be noted that the Debenture Sinking Fund will more than provide, during the currency of the Debentures, for the sums chargeable during those years in respect of amortisation of Capital. It will be recalled that the sum to be set aside was £6500 a year, but that the Directors decided that this should be increased to £7000, in order to be on the safe side. Further, the £6500 was arrived at on the basis of the appropriation to the Sinking Fund accumulated at 4 per cent. Bearing in mind, however, that, under the terms of the Debenture Trust Deed, these accumulations will be utilised in the purchase and cancellation of Debentures at or under £105 per £100 Debenture, the Sinking Fund, instead of accumulating on a 4 per cent basis, is really accumulating on a considerably higher basis.

Reference to Sinking Fund Tables shows that a sum of £7000 per annum set aside and accumulated at 6 per cent amounts to over £300,000 within twenty-two years. It is therefore apparent that within this period the Sinking Fund of £7000 suggested in the above Example will have redeemed the whole of the Debenture Debt of £300,000.

In considering the possible alternative of issuing Preference Shares instead of Debentures, it must be borne

in mind that unless the Company decides to distribute profits without making any provision for amortisation of Capital (in which event, when the economic life of the Colliery was over and the Company went into liquidation, there would be nothing to return to the shareholders in respect of their investment) the Company is faced with the necessity of providing for amortisation of Capital by means of a Sinking Fund. If there is no Debenture Debt which can be reduced out of the Sinking Fund provision, then the only alternative would be for the Company to purchase high-class Stock Exchange Securities, or, alternatively, to take out a policy with an Insurance Company. In the case of both these latter courses the Sinking Fund would not, in effect, compound at so high a rate as 6 per cent or 7 per cent. Indeed, it would only be prudent to assume that the rate would be as low as 4 per cent or even lower, bearing in mind that the accumulations would consist of income which had been subjected to a deduction for Income Tax. In this respect, therefore, there is an obvious advantage in having a Debenture Issue. It is true that when the Debenture Issue has been entirely redeemed by means of the Sinking Fund, the Company may still feel itself under the obligation to continue a provision for amortisation of Capital, and the sums thus provided would presumably either be invested in Stock Exchange Securities or paid over to an Insurance Company in the form of premiums on policies. This, however, cannot be avoided.

The following point may be of importance in considering, in the case of a Company owning a wasting asset, the alternatives of distributing the whole of the profits in dividend or accumulating an amortisation fund, invested outside the business. If a large proportion of the capital of the Company is held by wealthy shareholders whose incomes are assessable to Sur Tax, the latter tax would have to be paid by them on all dividends

received: if, however, some of the profits, instead of being distributed in dividend, were placed to an amortisation fund as mentioned above, then, when the economic life of the asset had expired and the Company was wound up, the outside investments representing this fund would be distributed by the liquidator, and such distributions would not rank as income of the recipients for purposes of Sur Tax.

An exception to this has, however, to be noted in the case of Companies whose shares are in a few hands: in such instances the Inland Revenue Authorities can, under certain circumstances, treat the income of each shareholder for Sur Tax purposes as being his proportion of the total profits of the Company, and not merely his proportion of the total sum distributed in dividend. For further details in this connection, reference should be made to the Finance Acts.

Another point to be borne in mind is that as the Ordinary Shareholders have the full control over the affairs of the Company (assuming that the obligations to the Debenture-holders have been promptly met) they could at any time pass the necessary Resolution for increasing the Share Capital if additional Capital were required for purposes of extending or developing the mine; and these new shares could be either Preference or Ordinary Shares.

APPENDIX E

BRIEF NOTES ON CERTAIN PROVISIONS IN THE MINING INDUSTRY ACT 1926, AND THE COAL MINES ACT 1930

BRIEF NOTES ON CERTAIN PROVISIONS IN THE MINING INDUSTRY ACT 1926, AND THE COAL MINES ACT 1930.

THE above two Acts are of particular interest as embodying legislation to promote joint working arrangements and amalgamations in an industry where it is considered that such steps are specially desirable in the interests of the industry itself and also in the national interest.

In the Mining Industry Act 1926 a number of provisions are made with the object of facilitating the reorganisation of the coal mining industry.

In particular, the Act gives to the owners of coal mining undertakings the right to prepare and submit to the Board of Trade schemes for the amalgamation of their undertakings or the absorption by one undertaking of another, or other undertakings. *Inter alia*, the Act gives the Board of Trade the power to consider a scheme prepared by certain parties to a proposed amalgamation with other parties, notwithstanding the fact that the last-mentioned parties may be opposed to the suggested merger.

The amalgamations contemplated under this Act may be total amalgamations or they may be partial amalgamations; and the Act outlines the general character of the contents of such schemes.

If the Board of Trade is satisfied, in regard to a scheme submitted to it, that a *prima facie* case is made out that such scheme would promote the more economical and efficient working, treating or disposal of coal, it may refer the matter to the Railway and Canal Commission.

This latter body, after considering the scheme and hearing any objections made by any party or parties, may confirm the scheme if it so decides, or it may modify the scheme. The scheme as confirmed by the Railway and Canal Commission is then binding on all parties.

The Coal Mines Act 1930 has for its main object the regulation and facilitation of the production, supply and sale of coal by owners of coal mines.

It provides that for this purpose there shall be a Central Scheme to be administered by a central council, and District Schemes relating to each coal mining area, each of such latter schemes to be worked by an Executive Board.

The Board of Trade has the power to approve a central scheme submitted by those representing a majority of the owners of coal mines in Great Britain; and in default of such scheme being so submitted within a certain time the Board of Trade itself is to prepare a scheme. A similar provision is in operation with regard to the district schemes.

The Act outlines the main classes of provisions of the central scheme, including the allocation of the maximum outputs for each district. Similarly, the main classes of provisions for the district schemes are set out, including the determination of the standard tonnage output of each coal mine in the district.

The Act also provides for the constitution of Committees of Investigation to consider complaints with respect to the operation of the various schemes.

There is also brought into being under the Act a Coal Mines Reorganisation Commission to further the reorganisation of the industry with a view to facilitating the production, supply and sale of coal.

The foregoing notes represent, in barest outline, the chief provisions of the two Acts above referred to so far as these are incidental to amalgamations. Readers who are specially interested in the coal mining industry should study the Acts themselves, where matters are, of course, gone into in much greater detail.

APPENDIX F

CLAUSES IN THE FINANCE ACTS 1927 AND 1928 RELATING TO RELIEF FROM CAPITAL AND TRANSFER STAMP DUTY IN CASE OF RECONSTRUCTIONS OR AMALGAMATIONS OF COMPANIES

CLAUSE IN THE FINANCE ACT 1927 RELATING TO RELIEF FROM CAPITAL AND TRANSFER STAMP DUTY IN CASE OF RECONSTRUCTIONS OR AMALGAMATIONS OF COMPANIES.

55. (1) If in connection with a scheme for the reconstruction of any company or companies or the amalgamation of any companies it is shewn to the satisfaction of the Commissioners of Inland Revenue that there exist the following conditions, that is to say—

(*a*) that a company with limited liability is to be registered, or that since the commencement of this Act a company has been incorporated by letters patent or Act of Parliament, or the nominal share capital of a company has been increased;

(*b*) that the company (in this section referred to as "the transferee company") is to be registered or has been incorporated or has increased its capital with a view to the acquisition either of the undertaking of, or of not less than ninety per cent of the issued share capital of, any particular existing company;

(*c*) that the consideration for the acquisition (except such part thereof as consists in the transfer to or discharge by the transferee company of liabilities of the existing company) consists as to not less than ninety per cent thereof—

(i) where an undertaking is to be acquired, in the issue of shares in the transferee company to the existing company or to holders of shares in the existing company; or

(ii) where shares are to be acquired, in the issue

of shares in the transferee company to the holders of shares in the existing company in exchange for the shares held by them in the existing company; then, subject to the provisions of this section—

(A) The nominal share capital of the transferee company, or the amount by which the capital of the transferee company has been increased, as the case may be, shall, for the purpose of computing the stamp duty chargeable in respect of that capital, be treated as being reduced by either:

(i) an amount equal to the amount of the share capital of the existing company, in respect of which stamp duty has been paid, or, in the case of the acquisition of a part of an undertaking, equal to such proportion of the said share capital as the value of that part of the undertaking bears to the whole value of the undertaking; or

(ii) the amount to be credited as paid up on the shares to be issued as such consideration as aforesaid, whichever amount is the less; and

(B) Stamp duty under the heading "Conveyance or Transfer on Sale" in the First Schedule of the Stamp Act 1891, shall not be chargeable on any instrument made for the purposes of or in connection with the transfer of the undertaking or shares, nor shall any such duty be chargeable under section twelve of the Finance Act 1895, on a copy of any Act of Parliament, or on any instrument vesting, or relating to the vesting of, the undertaking or shares in the transferee company:

Provided that—

(*a*) no such instrument shall be deemed to be duly stamped unless either it is stamped with the

duty to which it would but for this section be liable or it has in accordance with the provisions of section twelve of the Stamp Act 1891 been stamped with a particular stamp denoting either that it is not chargeable with any duty or that it is duly stamped, and

(*b*) in the case of an instrument made for the purposes of or in connection with a transfer to a company within the meaning of the Companies (Consolidated) Act 1908, the provisions of paragraph (B) of this subsection shall not apply unless the instrument is either—

(i) executed within a period of twelve months from the date of the registration of the transferee company or the date of the resolution for the increase of the nominal share capital of the transferee company, as the case may be; or

(ii) made for the purpose of effecting a conveyance or transfer in pursuance of an agreement which has been filed, or particulars of which have been filed, with the registrar of companies within the said period of twelve months.

(2) For the purposes of a claim for exemption under paragraph (B) of subsection (1) of this section, a company which has, in connection with a scheme of reconstruction or amalgamation, issued any unissued share capital shall be treated as if it had increased its nominal share capital.

(3) A company shall not be deemed to be a particular existing company within the meaning of this section unless it is provided by the memorandum of association of, or the letters patent or Act incorporating, the transferee company that one of the objects for which the company is established is the acquisition of the undertaking of, or shares in, the existing company, or unless

it appears from the resolution, Act or other authority for the increase of the capital of the transferee company that the increase is authorised for the purpose of acquiring the undertaking of, or shares in, the existing company.

(4) In a case where the undertakings of or shares in two or more companies are to be acquired, the amount of the reduction to be allowed under this section in respect of the stamp duty chargeable in respect of the nominal share capital or the increase of the capital of a company shall be computed separately in relation to each of those companies.

(5) Where a claim is made for exemption under this section, the Commissioners of Inland Revenue may require the delivery to them of a statutory declaration in such form as they may direct, made in England by a solicitor of the Supreme Court, or in Scotland by an enrolled law agent, and of such further evidence, if any, as the Commissioners may reasonably require.

(6) If—

(*a*) where any claim for exemption from duty under this section has been allowed, it is subsequently found that any declaration or other evidence furnished in support of the claim was untrue in any material particular, or that the conditions specified in subsection (1) of this section are not fulfilled in the reconstruction or amalgamation as actually carried out; or

(*b*) where shares in the transferee company have been issued to the existing company in consideration of the acquisition, the existing company within a period of two years from the date, as the case may be, of the registration or incorporation, or of the authority for the increase of the capital, of the transferee company ceases, otherwise than in consequence of re-

construction, amalgamation or liquidation, to be the beneficial owner of the shares so issued to it; or

(*c*) where any such exemption has been allowed in connection with the acquisition by the transferee company of shares in another company, the transferee company within a period of two years from the date of its registration or incorporation or of the authority for the increase of its capital, as the case may be, ceases, otherwise than in consequence of reconstruction, amalgamation or liquidation, to be the beneficial owner of the shares so acquired;

the exemption shall be deemed not to have been allowed, and an amount equal to the duty remitted shall become payable forthwith, and shall be recoverable from the transferee company as a debt due to His Majesty, together with interest thereon at the rate of five per cent per annum in the case of duty remitted under paragraph (A) of subsection (1) of this section from the date of the registration or incorporation of the transferee company or the increase of its capital, as the case may be, and in the case of duty remitted under paragraph (B) of the said subsection from the date on which it would have become chargeable if this Act had not passed.

(7) If in the case of any scheme of reconstruction or amalgamation the Commissioners of Inland Revenue are satisfied that at the proper time for making a claim for exemption from duty under subsection (1) of this section there were in existence all the necessary conditions for such exemption other than the condition that not less than ninety per cent of the issued share capital of the existing company would be acquired by the transferee company, the Commissioners may, if it is proved to their satisfaction that not less than ninety per cent of the issued capital of the existing company has under the scheme

been acquired within a period of six months from the earlier of the two following dates, that is to say :

(*a*) the last day of the period of one month after the first allotment of shares made for the purposes of the acquisition ; or

(*b*) the date on which an invitation was issued to the shareholders of the existing company to accept shares in the transferee company ;

and on production of the instruments on which the duty paid has been impressed, direct repayment to be made of such an amount of duty as would have been remitted if the said condition had been originally fulfilled.

(8) In this section, unless the context otherwise required :

References to the undertaking of an existing company include references to a part of the undertaking of an existing company ;

The expression " shares " includes stock.

CLAUSE IN THE FINANCE ACT 1928 RELATING TO RELIEF FROM CAPITAL AND TRANSFER STAMP DUTY IN CASE OF RECONSTRUCTIONS OR AMALGAMATIONS OF COMPANIES

31. Subsection (1) of section fifty-five of the Finance Act 1927 (which relates to relief from capital and transfer stamp duty in the case of reconstructions or amalgamations of companies) shall be amended as follows:

(1) The following shall be substituted for paragraph (A) (ii):

(ii) the amount to be credited as paid up on the shares to be issued as such consideration as aforesaid and on the shares, if any, to be issued to creditors of the existing company in consideration of the release of debts (whether secured or unsecured) due or accruing due to them from the existing company or of the assignment of such debts to the transferee company.

(2) In paragraph (B) there shall be inserted after the words "transfer of the undertaking or shares" the words "or on any instrument made for the purposes of or in connection with the assignment to the transferee company of any debts, secured or unsecured, of the existing company".

(3) At the end there shall be inserted the following additional proviso:

"; and

(*c*) the foregoing provision with respect to the release and assignment of debts of the existing company shall not, except in the case of debts due to banks or to trade creditors, apply to debts which were incurred less than two years before the proper time for making a claim for exemption under this section".

APPENDIX G

EXTRACTS FROM COMPANIES ACT 1929 IN REGARD TO HOLDING COMPANIES

EXTRACTS FROM COMPANIES ACT 1929 IN REGARD TO HOLDING COMPANIES

125. Where any of the assets of a company consist of shares in, or amounts owing (whether on account of a loan or otherwise) from a subsidiary company or subsidiary companies, the aggregate amount of those assets, distinguishing shares and indebtedness, shall be set out in the balance sheet of the first-mentioned company separately from all its other assets, and where a company is indebted, whether on account of a loan or otherwise, to a subsidiary company or subsidiary companies, the aggregate amount of that indebtedness shall be set out in the balance sheet of that company separately from all its other liabilities.

126. (1) Where a company (in this section referred to as "the holding company") holds shares either directly or through a nominee in a subsidiary company or in two or more subsidiary companies, there shall be annexed to the balance sheet of the holding company a statement, signed by the persons by whom in pursuance of section one hundred and twenty-nine of this Act the balance sheet is signed, stating how the profits and losses of the subsidiary company, or, where there are two or more subsidiary companies, the aggregate profits and losses of those companies, have, so far as they concern the holding company, been dealt with in, or for the purposes of, the accounts of the holding company, and in particular how, and to what extent:

(*a*) provision has been made for the losses of a subsidiary company either in the accounts of that company or of the holding company, or of both; and

(*b*) losses of a subsidiary company have been taken into account by the directors of the holding company in arriving at the profits and losses of the holding company as disclosed in its accounts.

Provided that it shall not be necessary to specify in any such statement the actual amount of the profits or losses of any subsidiary company, or the actual amount of any part of any such profits or losses which has been dealt with in any particular manner.

(2) If in the case of a subsidiary company the auditors' report on the balance sheet of the company does not state without qualification that the auditors have obtained all the information and explanations they have required and that the balance sheet is properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them and as shewn by the books of the company, the statement which is to be annexed as aforesaid to the balance sheet of the holding company shall contain particulars of the manner in which the report is qualified.

(3) For the purposes of this section, the profits or losses of a subsidiary company mean the profits or losses shewn in any accounts of the subsidiary company made up to a date within the period to which the accounts of the holding company relate, or, if there are no such accounts of the subsidiary company available at the time when the accounts of the holding company are made up, the profits or losses shewn in the last previous accounts of the subsidiary company which became available within that period.

(4) If for any reason the directors of the holding company are unable to obtain such information as is

necessary for the preparation of the statement aforesaid, the directors who sign the balance sheet shall so report in writing and their report shall be annexed to the balance sheet in lieu of the statement.

127. (1) Where the assets of a company consist in whole or in part of shares in another company, whether held directly or through a nominee and whether that other company is a company within the meaning of this Act or not, and:

(*a*) the amount of the shares so held is at the time when the accounts of the holding company are made up more than fifty per cent of the issued share capital of that other company or such as to entitle the company to more than fifty per cent of the voting power in that other company; or

(*b*) the company has power (not being power vested in it by virtue only of the provisions of a debenture trust deed or by virtue of shares issued to it for the purpose in pursuance of those provisions) directly or indirectly to appoint the majority of the directors of that other company,

that other company shall be deemed to be a subsidiary company within the meaning of this Act, and the expression "subsidiary company" in this Act means a company in the case of which the conditions of this section are satisfied.

(2) Where a company, the ordinary business of which includes the lending of money, holds shares in another company as security only, no account shall for the purpose of determining under this section whether that other company is a subsidiary company be taken of the shares so held.

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